

CA FINAL: Advanced Auditing and Professional Ethics

Question Bank Applicable For CA Final - May 2021

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CHAPTER - 1

Standards on Auditing

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SQC 1 – Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

Question 1

BSS & Associates is a partnership firm of Chartered Accountants which was established five years back. The firm was offering only advisory services at the beginning, however, after audit rotation and advent of GST, firm sees lot of potential in these areas also and started looking for opportunities in these areas also. These services being assurance in nature, the firm required some internal restructuring and set up some policies and procedures for compliance year on year.

The firm started getting new clients for these new services and is now looking to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it has been setting up a process to document how the issues were resolved.

The firm is now looking to work with only select clients which are in line with the policies of the firm. The firm understands that the extent of knowledge it will have regarding the integrity of a client will grow within the context of an ongoing relationship with that client. With regard to the integrity of a client, you are required to give some examples of the matters to be considered by the firm as per the requirements of SQC 1.

Or

MB & Associates is a partnership firm of Chartered Accountants which was established seven years back. The firm is getting new clients and has also, been offered new engagement services with existing clients. The firm is concerned about obtaining such information as it considers necessary in the circumstances before accepting an engagement with a new client and acceptance of a new engagement with an existing client. The firm is looking to work with only select clients to adhere to the Quality Control Standards. Guide MB & Associates about the matters to be considered with regard to the integrity of a client, as per the requirements of SQC 1.

Answer

As per **SQC 1**, the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- (i) The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- (ii) The nature of the client's operations, including its business practices.
- (iii) Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- (iv) Whether client is aggressively concerned with maintaining firm's fees as low as possible.
- (v) Indications of an inappropriate limitation in the scope of work.
- (vi) Indications that client might be involved in money laundering or other criminal activities.
- (vii) The reasons for proposed appointment of firm and non-reappointment of previous firm.
- (viii) The extent of knowledge a firm will have regarding the integrity of a client will generally

grow within the context of an ongoing relationship with that client.

SA 200 – Overall Objectives of the Independent Auditor and the Conduct of an Audit as per SA

Question 2

Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.

Answer

According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk, has two components: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement X Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components Inherent risk and Control risk. The relationship can be defined as

Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. 40% X 25 % = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows: Audit Risk: Risk of Material Misstatement X Detection Risk = 10 X 40% = 4%

SA 210 – Agreeing the Terms of Audit Engagements

Question 3

Mr. Ram Kapoor, Chartered Accountant, has been appointed as the statutory auditor by XYZ Private Limited for the audit of their financial statements for the year 2020-21. The company has mentioned in the audit terms that they will not be able to provide internal audit reports to Mr. Ram during the course of audit. Further, company also imposed some limitation on scope of Mr. Ram.

What are the preconditions Mr. Ram should ensure before accepting/ refusing the proposal? Also advise, whether Mr. Ram should accept the proposed audit engagement?

Answer

As per **SA 210 “Agreeing the Terms of Audit Engagements”**, in order to establish whether the preconditions for an audit are present, the auditor shall:

- (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
 - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - (iii) To provide the auditor with:
 - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
 - b. Additional information that the auditor may request from management for the purpose of the audit; and
 - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Further, if management or those charged with governance impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

In addition if the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement.

In the instant case, Mr. Ram should not accept the appointment as statutory auditor of XYZ Private Limited due to limitation imposed on his scope of work.

Question 4

AKJ Ltd is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.

The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since the statutory audit is mandated by law, engagement letter may not be required. Auditors did not agree to this and have shared a format of engagement letter with the management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in terms of agreed audit engagement letter?

Answer

As per SA 210 Agreeing the Terms of Audit Engagements The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (i) The objective and scope of the audit of the financial statements;
- (ii) The responsibilities of the auditor;
- (iii) The responsibilities of management;
- (iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Question 5

MEA Limited is a listed company having its operation across India. MEA Limited appointed Mr. X, Mr. Y and Mr. Z, as its joint auditors for the year 2020-21. After making sure that all of them are qualified to be appointed as statutory auditor, MEA Limited issued engagement letter to all of them. But Mr. X was not clear on some points, so he requested MEA Limited to slightly change the terms of his engagement. This change will not impact the ultimate opinion on the financial statement. The engagement letter contains the details on objective and scope of audit, responsibilities of auditor and identification of framework applicable. It also contains the reference to expected form and content of report from all three joint auditors. In your opinion what was the discrepancy in the Audit engagement letter issued by MEA Limited?

Answer

Agreement on Audit Engagement Terms: As per SA 210, "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

Subject to prescribed details under Law or Regulations, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (i) The objective and scope of the audit of the financial statements;

- (ii) The responsibilities of the auditor;
- (iii) The responsibilities of management;
- (iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

In the given scenario, MEA Limited appointed Mr. X, Mr. Y and Mr. Z, as its joint auditors for the year 2020-21 and issued engagement letter to all of them. The engagement letter contains the details on objective and scope of audit, responsibilities of auditor, identification of framework applicable and reference to expected form and content of report from all three joint auditors. However, engagement letter issued by MEA Ltd. does not specify the responsibilities of management, whereas as per SA 210, it should also specify responsibilities of management.

Question 6

R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients, for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement.

Answer

As per SA 210 on “Agreeing the Terms of Audit Engagements”, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change of senior management.
- (iv) A significant change in ownership.
- (v) A significant change in nature or size of the entity’s business.
- (vi) A change in legal or regulatory requirements.
- (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
- (viii) A change in other reporting requirements.

SA 220 – Quality Control for an Audit of Financial Statements

Question 7

During the audit of FMP Ltd, a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the audit engagement. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) except the independence assessment documentation. Engagement Partner was of the view that matters related to independence assessment are the responsibility of the Engagement Partner and not Engagement Quality Control Reviewer. Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Please advise as per SA 220.

Answer

As per SA 220, Engagement Partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, Engagement Partner shall:

- Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Engagement Partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

As per SA 220, "Quality Control for Audit of Financial Statements", for audits of financial statements of listed entities, Engagement Quality Control Reviewer (EQCR), on performing an engagement quality control review, shall also consider the engagement team's evaluation of the firm's independence in relation to the audit engagement.

In the given case, Engagement Partner is not right. The independence assessment documentation should also be given to Engagement Quality Control Reviewer for his review.

Question 8

M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2020-21. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29th May, 2021. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh. State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

Answer

As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have

taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried, is that when the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.

Question 9

OP & Associates are the statutory auditors of BB Ltd. BB Ltd is a listed company and started its operations 5 years back. The field work during the audit of the financial statements of the company for the year ended 31 March 2021 got completed on 1 May 2021. The auditor's report was dated 12 May 2021. During the documentation review of the engagement, it was observed that the engagement quality control review was completed on 15 May 2021. Engagement partner had completed his reviews in entirety by 10 May 2021. Please comment.

Answer

As per SA 220, the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. For audits of financial statements of listed entities, the **engagement partner shall:**

- Determine that an **engagement quality control reviewer has been appointed;**
- **Discuss significant matters arising during the audit engagement**, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- **Not date the auditor's report** until the completion of the engagement quality control review.

SA 700 also requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements. In cases of an audit of financial statements of listed entities where the engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement **allows significant matters to be promptly resolved** to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

In the given case, the signing of auditors' report before completion of review of engagement quality control review is not right.

SA 230 – Audit Documentation

Question 10

Discuss the Auditor's responsibility to provide access to his audit working papers to Regulators and third parties.

Answer

The auditor should not provide access to working papers to any third party without specific authority or unless there is a legal or professional duty to disclose. Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by law for the time being in force. SA 200 on "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of the information obtained and should not disclose any such information to any third party without specific authority or unless there is a legal or professional duty to disclose".

If there is a request to provide access by the regulator based on the legal requirement, the same has to be complied with after informing the client about the same.

Further, Standard on Quality Control (SQC) 1 provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

As per SA 230, Audit documentation serves a number of additional purposes, including the enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Therefore, it is auditor's responsibility to provide access to his audit working papers to Regulators whereas it's at auditor's discretion, to make portions of, or extract from his working paper to third parties.

Question 11

Mr. A, a practising Chartered Accountant, has been appointed as an auditor of True Pvt. Ltd. What factors would influence the amount of working papers required to be maintained for the purpose of his audit?

Answer

As per SA 230 "Audit Documentation", which refers to the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached, the amount of audit working papers depend on factors such as-

- (i) The size and complexity of the entity.
- (ii) The nature of the audit procedures to be performed.
- (iii) The identified risks of material misstatement.
- (iv) The significance of the audit evidence obtained.
- (v) The nature and extent of exceptions identified.

- (vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- (vii) The audit methodology and tools used.
- (viii) Timely preparation of Audit Documentation.

SA 240 – The Auditor’s responsibilities relating to Fraud in an Audit of Financial Statements

Question 12

While auditing accounts of a public limited company for the year ended 31st March 2021, an auditor found out an error in the valuation of inventory, which affects the financial statement materially. Comment as per standards on auditing.

Answer

SA 240, “The Auditor’s Responsibilities Relating Fraud in an Audit of Financial Statements”, requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. Further, SA 320 Materiality in Planning and Performing an Audit, also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

Question 13

M/s Honest Limited has entered into a transaction on 5th March, 2021, near year-end, whereby it has agreed to pay ₹ 5 lakhs per month to Mr. Y as annual retainer-ship fee for "engineering consultation". No amount was actually paid, but ₹ 60 lakhs is provided in books of account as on March 31, 2021.

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

Answer

As per SA 240 on “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to

manipulate operating results or achieve other objectives.

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

Accordingly, the auditor would adopt the following approach-

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

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

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹ 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 14

In the course of audit of K Ltd., its auditor Mr. 'N' observed that there was a special audit conducted at the instance of the management on a possible suspicion of a fraud and requested for a copy of the report to enable him to report on the fraud aspects. Despite many reminders it was not provided. In absence of the special audit report, Mr. 'N' insisted that he be provided with at least a written representation in respect of fraud on/by the company. For this request also, the management remained silent. Please guide Mr. 'N'.

Answer

As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

As per SA 580 "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist.

In the instant case, the auditor observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report which was not provided by the management despite of many reminders. The auditor also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent.

It may be noted that, if management does not provide one or more of the requested written representations, the auditor shall discuss the matter with management; re- evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Accordingly, the auditor would adopt the following approach-

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

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

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹ 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 15

In the course of audit of A Ltd. you suspect the management has indulged in fraudulent financial reporting. State the possible source of such fraudulent financial reporting.

Answer

As per SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. It may be accomplished by manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared or Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information or intentional

misstatements involve intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure etc.

It often involves management override of controls, misappropriation of assets etc that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- (i) Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- (ii) Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- (iii) Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period. Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- (iv) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- (v) Altering records and terms related to significant and unusual transactions.
- (vi) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- (vii) Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- (viii) Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- (ix) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Question 16

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

Answer

Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor, conducting an audit, is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As described in SA 200, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it,

such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls

and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹ 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 17

While conducting statutory Audit of ABC Ltd., you come across I Owe you amounting to ₹ 2 crores as against a cash balance shown in books of ₹ 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of ₹ 50,000 are withdrawn from the bank to meet day-to-day expenses. As a Statutory Auditor, how would you deal?

Answer

According to SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect t on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

Question 18

You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a Statutory Auditor, how would you

deal?

Answer

According to SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor’s ability to continue performing the audit, the auditor shall:

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

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹ 1 crore) within such time and in such manner as may be prescribed.

Question 19

The Managing Director of the Company has committed a “Teeming and Lading” Fraud. The amount involved has been however subsequently after the year end deposited in the company. As a Statutory Auditor, how would you deal?

Answer

The Managing Director of the company has committed a “Teeming and Lading” fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240, “The Auditor’s responsibilities relating to Fraud in an Audit of Financial Statements”. First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of

fraud is ₹ 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹ 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 20

You are appointed as an auditor of Global Ltd. Explain the risk factors relating to misstatements arising from misappropriation of assets.

Answer

As per SA 240, "The Auditor's Responsibilities Relating to Fraud in audit of Financial Statements", misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Risk factors that relate to misstatements arising from misappropriation of assets are classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. The following are examples of risk factors related to misstatements arising from misappropriation of assets:

Incentives/Pressures: Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
 1. Known or anticipated future employee layoffs.
 2. Recent or anticipated changes to employee compensation or benefit plans.
 3. Promotions, compensation or other rewards inconsistent with expectations.

Opportunities: Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Inventory items that are small in size, of high value, or in high demand.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets.
- Inadequate segregation of duties or independent checks.

Attitudes/Rationalizations:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.

SA 250 – Consideration of Laws and Regulations in an Audit of Financial Statements

Question 21

What are the roles and responsibilities of the statutory auditors in relation to compliance with the laws and regulations by the entity?

Answer

As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”, as part of obtaining an understanding of the entity and its environment the auditor shall obtain a general understanding of:

- (i) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
- (ii) How the entity is complying with that framework.

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

- (i) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- (ii) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor’s attention. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

Thus, the auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.

Question 22

R & M Co. wants to be alert on the possibility of non-compliance with Laws and Regulations during the course of audit of SRS Ltd. R & M Co. seeks your guidance for identifying the indications of non compliance with Laws and Regulations.

Answer

As per SA 250, “Consideration of Laws and Regulations, the auditor shall perform the audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements by inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

However, when the auditor becomes aware of the existence of, or information about, the following matters, it may also be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Question 23

While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws.

Answer

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

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

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

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

Question 24

State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement.

Answer

According to SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the reporting responsibilities of an Auditor may be divided into the following categories-

Reporting Non-Compliance to Those Charged with Governance: Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance referred above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements: If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705 express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities: If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Question 25

PQ Limited, a listed entity, is in the business of manufacturing of specialty chemicals. The company has appointed CA Jazz as CFO of the company. CA Jazz is concerned about compliance with the provisions of laws and regulations that determine the reported amounts and disclosure in financial statements of PQ Limited. Accordingly CA Jazz wants to implement such policies and procedures that can assist him in the prevention and detection of non-compliance with laws and regulations. Help CA Jazz by citing examples of such policies and procedures.

Answer

As per SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”, the following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicising and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

SA 260 – Communication with Those Charged with Governance**Question 26**

“The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity”. Briefly state the matters to be included in such Communication.

Answer

As per SA 260 “Communication with those Charged with Governance”, the auditor shall communicate with those charged with governance, the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor shall communicate with those charged with governance the following:

- (a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
- (b) Significant difficulties, if any, encountered during the audit;
- (c) Unless all of those charged with governance are involved in managing the entity:
 - (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
 - (ii) Written representations the auditor is requesting; and
- (d) Other matters, if any, arising from the audit that, in the auditor’s professional judgment, are significant to the oversight of the financial reporting process.

Question 27

SA 260 requires the auditor to communicate with those charged with governance on a timely basis. The appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance. Explain in detail why it is important to communicate key audit matters to those charged with governance.

Answer

SA 260 (Revised) requires the auditor to communicate with those charged with governance on a timely basis. The appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two-way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion. Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

SA 265 – Communicating Deficiencies in Internal Control to TCWG and Management

Question 28

During the course of audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in the mind while drafting the letter of weaknesses in internal control system.

Answer

Important Points to be kept in Mind While Drafting Letter of Weakness: As per SA 265, “Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management”, the auditor shall include in the written communication of significant deficiencies in internal control -

- (i) A description of the deficiencies and an explanation of their potential effects; and
- (ii) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should communicate material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows-

- (1) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.
- (2) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.
- (3) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.
- (4) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

Question 29

Auditors are required to obtain an understanding of internal control relevant to the audit when identifying and assessing its effectiveness and risk of material misstatement. During the course of audit of ABC Ltd., you observed that significant deficiency exists in the internal control system and you want to ascertain the same. Elucidate the various indicators of significant deficiencies which will help you in assessing the efficiency of internal control system of the organization.

Answer

As per SA 265, “Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management”, indicators of significant deficiencies in internal control include, for example:

- Evidence of ineffective aspects of the control environment, such as:
 - Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.

- Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
- Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss²⁸.
- Evidence of management's inability to oversee the preparation of the financial statements.

Question 30

CA.N has been appointed as an auditor of TRP Ltd. While conducting the audit he has identified some deficiencies in the Internal control. He needs to determine whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency" and has to communicate them in writing to those charged with Governance and management on a timely basis. Guide CA.N with some examples of matters to be considered while determining 'significant deficiency' in internal control with reference to relevant SA.

Answer

As per SA 265, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management", examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process; for example:
 - General monitoring controls (such as oversight of management).
 - Controls over the prevention and detection of fraud.
 - Controls over the selection and application of significant accounting policies.
 - Controls over significant transactions with related parties.
 - Controls over significant transactions outside the entity's normal course of business.
 - Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

SA 299 – Joint Audit of Financial Statements

Question 31

Write a short note on Responsibility of Joint Auditors.

Answer

SA 299 on, “Joint Audit of Financial Statements” deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 2013. Main features of the said SA are discussed below:

- **Division of Work:** Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- **Coordination:** Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

- (a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them.
- (b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
- (c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors.
- (d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.
- (e) for ensuring that the audit report complies with the requirements of the relevant statute.
- (f) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.
- (g) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.
- (h) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 32

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct auditing for the financial year 2020-21. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuary reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma.

You are required to briefly explain the responsibilities of auditors when they are jointly and severally responsible in respect of audit conducted by them and also guide Mr. Z in such situation.

Answer

SA 299 on, "Joint Audit of Financial Statements" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

- (i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- (ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors;
- (iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- (iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute;
- (v) for ensuring that the audit report complies with the requirements of the relevant statute;
- (vi) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit;
- (vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors;
- (viii) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

In the instant case, there are three auditors, namely, Mr. X, Mr. Y and Mr. Z, jointly appointed as an auditor of KRP Ltd. For the valuation of gratuity scheme of the Company they referred their own known Actuaries. Mr. Z (one of the joint auditor) is not satisfied with the report submitted by Mr. Y's referred actuary. He is not agreed with the matters to be covered by the report whereas Mr. X agreed with the same.

Hence, as per SA 299, Mr. Z is suggested to express his own opinion through a separate report whereas Mr. X and Mr. Y may provide their joint report for the same.

Question 33

P Limited is a listed company and its business activities are divided into three regions. The company appointed PY & Co., KL & Co. and MK & Co., Chartered Accountants to conduct a Joint Audit and report on the financial statements for the Financial Year 2020-21. Explain the relationship among the joint auditors for the audit of the financial statements for the year 2020-21.

Answer

SA 299 “Joint Audit of Financial Statements” deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. According to this SA, in respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him.

- I. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:
 - (i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
 - (ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
 - (iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
 - (iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
 - (v) for ensuring that the audit report complies with the requirements of the relevant statute.
- II. It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

SA 300 – Planning an Audit of Financial Statements

Question 34

Briefly discuss the following statements in view of SA 300 “Planning an Audit of Financial Statements”: For an initial audit, the auditor may need to expand the planning activities.

Answer

Additional Considerations in Initial Audit Engagements: As per SA 300, Planning an Audit of Financial Statements, the purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements.

For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor’s working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (as per SA 510 “Initial Audit Engagements– Opening Balances”).
- Other procedures required by the firm’s system of quality control for initial audit engagements (for example, the firm’s system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

SA 315 - Identifying and Assessing Risks of MM through Understanding the Entity and its Environment

Question 35

The identified risks are assessed by Auditor as to its significance on account of its likely impact, by way of material misstatement appearing in financial statements or by affecting internal control system. What may be the points of indication that may direct the Auditor to judge that the risks identified may be significant?

Or

You are engaged by M/s. Real Ltd. as an internal auditor for the financial year 2020-21. While applying risk assessment procedures of inquiring from management and various analytical procedures, you have identified some risks which in your opinion may lead to material misstatement at the financial level and assertion level. Which factors as an auditor will you consider while exercising judgement as to whether such risks are significant risks or not?

Answer

Points of Indication that may direct the Auditor to Judge that the Risks Identified may be Significant: As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment", as part of the risk assessment the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (i) Whether the risk is a risk of fraud;
- (ii) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (iii) The complexity of transactions;
- (iv) Whether the risk involves significant transactions with related parties;
- (v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Question 36

While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level.

Answer

SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk,

control risk and detection risk. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

Question 37

IT systems also pose specific risks to an entity's internal control? What are those risks?

Answer

As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are–

- (i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.
- (ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.
- (iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iv) Unauthorised changes to data in Master files.
- (v) Unauthorised changes to systems or programs.
- (vi) Failure to make necessary changes to systems or programs.
- (vii) In appropriate manual intervention.
- (viii) Potential loss of data or inability to access data as required.

Question 38

While commencing the statutory audit of ABC Company Limited, what should be the considerations of the auditor to assess Risk of Material Misstatement and his response to such risks?

Answer

SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall-

- (i) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the

classes of transactions, account balances, and disclosures in the financial statements;

- (ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (iii) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
- (iv) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Auditor's Responses to the Assessed Risk of Material Misstatement: According to SA 330 "The Auditor's Responses to Assessed Risks", the auditor shall design and implement overall responses to address the assessed risks of material misstatement. In designing the audit procedures to be performed, the auditor shall-

- (i) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - (1) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure; and
 - (2) Whether the risk assessment takes into account the relevant controls, thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively; and
- (ii) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Question 39

What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?

Answer

The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

- (i) Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework.
- (ii) The nature of the entity, including:
 - (1) its operations;
 - (2) its ownership and governance structures;
 - (3) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (4) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- (iii) The entity's selection and application of accounting policies.
- (iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- (v) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 40

What are the major sources of obtaining information about the client's business?

Answer

Information about the client's business: The auditor can obtain information about client's business from the following sources:

- (i) The client's annual Reports to shareholders;
- (ii) Minutes of meetings of shareholders, board of directors and important committees;
- (iii) Internal financial management report for current and previous periods, including budgets, if any;
- (iv) The previous year's audit working papers, and other relevant files;
- (v) Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit;
- (vi) Discussions with the client;
- (vii) The client's policy and procedures manual;
- (viii) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publication, trade Journals, magazines, newspapers or text books;
- (ix) Consideration of the state of the economy and its effects on the client's business;
- (x) Visits to the client's premises and plant facilities to the management.

SA 320 – Materiality in Planning and Performing an Audit

Question 41

Mr. X was appointed as the auditor of M/s Easygo Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose.

Answer

SA 320 “Materiality in Planning and Performing an Audit” prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

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

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

Question 42

As an auditor of RST Ltd. Mr. P applied the concept of materiality for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company’s business, he wants to re-evaluate the materiality concept. Please, guide him.

Answer

In the instant case, Mr. P, as an auditor of RST Ltd. has applied the concept of materiality for the financial statements as a whole. But he wants to re-evaluate the materiality concept on the basis of additional information of significant contractual arrangements which draws attention to a particular aspect of the company’s business.

As per SA 320 “Materiality in Planning and Performing an Audit”, while establishing the overall audit strategy, the auditor shall determine materiality for the financial statement as a whole. He should set the benchmark on the basis of which he performs his audit procedure. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor shall revise materiality for the financial statements in the event of becoming aware of

information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes a lower materiality for the same, then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

Thus, Mr P can re-evaluate the materiality concepts after considering the necessity of such revision.

SA 330 – The Auditor’s Responses to Assessed Risks

Question 43

In the course of audit of Z Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an advisor to the auditor kindly caution him about the factors that may warrant a re-test of controls.

Answer

As per SA 330 on “The Auditor’s Responses to Assessed Risks”, changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor’s decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment.

Factors that may warrant a re-test of controls are-

- (i) A deficient control environment.
- (ii) Deficient monitoring of controls.
- (iii) A significant manual element to the relevant controls.
- (iv) Personnel changes that significantly affect the application of the control.
- (v) Changing circumstances that indicate the need for changes in the control.
- (vi) Deficient general IT-controls.

Question 44

While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement?

Answer

As per SA 330, “The Auditor’s Response to Assessed Risk”, substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

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

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

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

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

SA 402 – Audit Considerations Relating to an Entity Using a Service Organization

Question 45

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

Answer

As per SA 402 on “Audit Considerations Relating to an Entity Using a Service Organisation”, when obtaining an understanding of the user entity in accordance with SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity’s operations, including:

- (i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity’s internal control;
- (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- (iii) The degree of interaction between the activities of the service organisation and those of the user entity; and
- (iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organization.

Question 46

A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit?

Answer

Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

As per SA 402 “Audit Considerations relating to an Entity using a Service Organization”, when obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity’s operations, including:

- (a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity’s internal control;

- (b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- (c) The degree of interaction between the activities of the service organisation and those of the user entity; and
- (d) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as user manuals; system overviews; technical manuals; the contract or service level agreement between the user entity and the service organisation; reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation; reports by the service auditor, including management letters, if available.

Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardized.

Question 47

When a sub-service organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used. As a user auditor what information would you obtain about controls at a sub-service organization?

Answer

In accordance with SA 402 "Audit Considerations relating to an Entity Using a Service Organisation", a user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation.

A user auditor may need to consider controls at the sub-service organisation. In situations where one or more sub-service organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the sub-service organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the sub-service organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation's and sub-service organisation's controls to the user entity's controls.

Further, the user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding by application of the following two methods of presenting description of internal controls i.e. (I) Type 1 report; or (ii) Type 2 report.

If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out

method respectively.

In either method, the service organisation includes in its description of controls a description of the functions and nature of the processing performed by the sub-service organisation.

If the Type 1 or Type 2 report excludes the control at a subservice organization and the services provided by the subservice organization are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of the SA 402 in respect of the subservice organization.

The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organization depend on the nature and significance of those services to the user entity and relevance of those services to the audit.

Question 48

Durafone Mobile Co. Ltd. have pan India presence and market leader in mobile operation. It has outsourced all its revenue operation including accounting functions to Set Solutions (P) Ltd. As an Auditor of the mobile company, enumerate the factors to be taken into consideration related to its financial reporting.

Answer

Factors to be considered by Auditor related to Financial reporting of Service organisation:

As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting.

Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

- (i) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
- (ii) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (iii) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
- (iv) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (v) The financial reporting process used to prepare the user entity's financial statements,
- (vi) including significant accounting estimates and disclosures; and
- (vii) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Question 49

How does an auditor report on the description, design and operating effectiveness of controls at a service organization?

Answer**Report on the Description, Design and Operating Effectiveness of Controls at a Service**

Organization: As per SA 402 “Audit Considerations Relating to an Entity using a Service Organisation”, a report on the description, design and operating effectiveness of controls at a service organization shall comprise-

- (i) A description, prepared by management of the service organisation, of the service organisation’s system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
- (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:
 - a. The service auditor’s opinion on the description of the service organisation’s system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
 - b. A description of the service auditor’s tests of the controls and the results thereof.

Question 50

ENN Limited is availing the services of APP Private Limited for its payroll operations. Payroll cost accounts for 65% of total cost for ENN Limited. APP Limited has provided the type 2 report as specified under SA 402 for its description, design and operating effectiveness of control.

APP Private Limited has also outsourced a material part of payroll operation M/s SMP & Associates in such a way that M/s SMP & Associates is sub-service organization to ENN Limited. The Type 2 report which was provided by APP Private Limited was based on carve-out method as specified under SA 402.

CA Raman while reviewing the unmodified audit report drafted by his assistant found that, a reference has been made to the work done by the service auditor. CA Raman hence asked his assistant to remove such reference and modify report accordingly.

Comment whether CA Raman is correct in removing the reference of the work done by service auditor?

Answer

Reporting by the User Auditor: As per SA 402, “Audit Considerations Relating to an Entity Using a Service Organisation”, the user auditor shall modify the opinion in the user auditor’s report in accordance with SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”, if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity’s financial statements.

The user auditor shall not refer to the work of a service auditor in the user auditor’s report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor’s report shall indicate that the reference does not diminish the user auditor’s responsibility for the audit opinion.

Thus, in view of above, contention of CA. Raman in removing reference of the work done by service auditor is in order as in case of unmodified audit report, user auditor cannot refer to the work done by service auditor.

SA 450 – Evaluation of Misstatements Identified during the Audits

Question 51

In audit plan for T Ltd, as the audit partner you want to highlight the sources of misstatements, arising from other than fraud, to your audit team and caution them. Identify the sources of misstatements.

Answer

According to SA 450 “Evaluation of Misstatements identified during the Audit”, the following are the sources of misstatements arising from other than fraud -

- (i) An inaccuracy in gathering or processing data from which the financial statements are prepared;
- (ii) An omission of an amount or disclosure;
- (iii) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts;
- (iv) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Question 52

Discuss the impact of uncorrected misstatements identified during the audit and the auditor's response to the same.

Or

The auditor of XY & Co. Ltd. has intimated the management that certain misstatements identified during the course of audit need to be corrected. As an auditor, discuss the impact of such misstatements in case the management does not carry out the said corrections.

Answer

In accordance with SA 450 “Evaluation of Misstatements identified during the Audit”, the auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider-

- (i) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- (ii) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

The auditor shall communicate this with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.

The auditor's communication shall identify material uncorrected misstatements individually. The

auditor shall request that uncorrected misstatements be corrected.

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320, to confirm whether it remains appropriate in the context of the entity's actual financial results.

As per management, if effect of such uncorrected misstatement is immaterial then the auditor shall request for a written representation from management and, where appropriate, those charged with governance that whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should report accordingly.

SA 500 – Audit Evidence

Question 53

Obtaining audit evidence in performing compliance and substantive procedures. Comment.

Answer

As per SA 500 “Audit Evidence”, in performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods-

- (i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity’s application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity’s rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

- (ii) **Observation:** Observation consists of looking at a process or procedure being performed by the others. For example, the auditor’s observation of inventory counting by the entity’s personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.
- (iii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition.
- (iv) **Recalculation:** Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.
- (v) **Reperformance:** It involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.
- (vi) **Analytical Procedure:** Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non- financial data. Analytical procedures also encompass the investigation of identified fluctuations and

relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) **Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Question 54

M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures. As a Statutory Auditor, how would you deal in this situation?

Or

The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. Comment.

Or

Y Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as an audit evidence. How do you evaluate the work of the actuary?

Answer

As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work

for the auditor's purposes, - Evaluate the competence, capabilities and objectivity of that expert;

- (a) Obtain an understanding of the work of that expert; and
- (b) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

- (i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- (ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- (iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

The auditor has to evaluate the work of an expert, say, actuary, before adopting the same.

This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that relevance and reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are appropriate based on the auditor's knowledge of the client's business and result of his audit procedures.

In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

Question 55

Gap Ltd. possesses some investment for which there is no ready market and to assess its fair market value it hires an expert, the result of which it can use in preparing its financial statement. Being an Auditor of the Company, state the matters which may affect the nature, timing and extent of audit procedure to be adopted by you in the instant case.

Answer

Nature, Timing and Extent of Audit Procedures: As per SA 500 "Audit Evidence", the nature, timing and extent of audit procedures to be adopted by an auditor in case of management's expert, may be affected by such matters as:

- (i) The nature and complexity of the matter to which the management's expert relates.
- (ii) The risks of material misstatement in the matter.
- (iii) The availability of alternative sources of audit evidence.
- (iv) The nature, scope and objectives of the management's expert's work.
- (v) Whether the management's expert is employed by the entity, or is a party engaged
- (vi) by it to provide relevant services.
- (vii) The extent to which management can exercise control or influence over the work of
- (viii) the management's expert.
- (ix) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- (x) The nature and extent of any controls within the entity over the management's expert's work.
- (xi) The auditor's knowledge and experience of the management's expert's field of expertise.
- (xii) The auditor's previous experience of the work of that expert.

SA 501 – Audit Evidence - Specific Considerations for Selected Items

Question 56

You are the auditor of Easy Communications Ltd. for the year 2020–21. The inventory as at the end of the year i.e. 31.3.21 was ₹ 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?

Answer

As per SA 501 “Audit Evidence – Additional Considerations for Specific Items”, the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. SA 501 is additional guidance to that contained in SA 500, “Audit Evidence”, with respect to certain specific financial statement amounts and other disclosures.

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management’s written representation on (a) the completeness of information provided regarding the inventory, and (b) assurance with regard to adherence to laid down procedures for physical inventory count.

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

Question 57

LMN Ltd. supplies navy uniforms across the country. The company has 4 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. LMN Ltd. appointed M/s OPQ & Co. to conduct its audit for the financial year 2020-21. Mr. O, partner of M/s OPQ & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

You are required to advise M/s OPQ & Co.,

- (i) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?
- (ii) How an auditor is supposed to deal when attendance at physical inventory counting is impracticable?

Answer

(i) Special Consideration with Regard to Inventory: As per SA 501 “Audit Evidence- Specific Considerations for Selected Items”, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(a) Attendance at physical inventory counting, unless impracticable, to:

- (1) Evaluate management’s instructions and procedures for recording and controlling the

results of the entity's physical inventory counting;

- (2) Observe the performance of management's count procedures;
- (3) Inspect the inventory; and
- (4) Perform test counts; and

(b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(ii) Attendance at Physical Inventory Counting Not Practicable: In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Further, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to the Opinion in the Independent Auditor's Report, requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Question 58

"If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence of inventory by attending the physical inventory counting unless impracticable". Discuss.

Answer

According to SA 501 "Audit Evidence - Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending the physical inventory counting, unless impracticable, to –

- (i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting.
- (ii) Observe the performance of management's count procedures.
- (iii) Inspect the inventory.
- (iv) Perform test counts.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

Question 59

Your firm has been appointed as the statutory auditors of GBM Private Limited for the financial year 2020-21. While verification of company's inventories as on 31st March 2021, you found that the significant amount of inventories belonging to the company are held by other parties. However, the company has kept all the records of the inventories maintained by other parties. What is your duty as an auditor in order to ensure that third parties are not such with whom the stock should not be held and the stock as disclosed in company's records actually belongs to them?

Answer

Inventory under the Custody and Control of a Third Party: As per SA 501, "Audit Evidence—Specific Considerations for Selected Items" when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

- (i) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
- (ii) Perform inspection or other audit procedures appropriate in the circumstances, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:
 - Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
 - Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
 - Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
 - Requesting confirmation from other parties when inventory has been pledged as collateral.

Question 60

GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2021 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.

Answer

As per SA 501, "Audit Evidence—Specific Considerations for Selected Items", Examples of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- Sales, transfers and charges between segments, and elimination of inter-segment amounts.
- Comparisons with budgets and other expected results, for example, operating profits as a

percentage of sales.

- The allocation of assets and costs among segments.
- Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Question 61

Moon Ltd. is a dealer in electronic appliances. The Company has a centralised warehouse at the outskirts of Mumbai. The Auditors of the company, M/s JK Associates normally attend, the physical verification of stocks carried out by the Management at the end of the financial year. However, on account of certain disturbances in the region, the physical inventory counting could not be carried out at the year end. The stock taking is decided to be done by management at some other date subsequently, after a month.

Enumerate the audit procedures to be considered by M/s JK Associates, if physical inventory counting is conducted at a date other than the date of the financial statements with reference to the relevant Standard on Auditing.

Answer

As per SA 501, “Audit Evidence—Specific Considerations for Selected Items”, If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity’s perpetual inventory records.
- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

SA 505 - External Confirmations

Question 62

The auditor of H Ltd. wanted to obtain confirmation from its trade payables. But the management made a request to the auditor not to seek confirmation from certain trade payables citing disputes. Can the auditor of H Ltd. accede to this request?

Answer

SA 505, "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the trade payables, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular trade payable, the request for confirmation might aggravate the sensitive negotiations between the entity and the trade payables.

In such cases, when an auditor agrees to management's request not to seek external confirmation regarding certain trade payables, the auditor should consider validity of grounds for such a request and assess management's integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request.

If the auditor of H Ltd. agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor of H Ltd. reaches at a conclusion that the same was not valid, he may appropriately modify the report.

Question 63

During the course of audit of Star Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables of small balances except one, old outstanding of ₹ 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing.

Answer

As per SA 505, "External Confirmation", Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the trade payables having

outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ₹ 15 lacs has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

Question 64

The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal?

Answer

SA 505 “External Confirmations”, establishes standards on the auditor’s use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to a send a confirmation request, the auditor shall:

- (i) Inquire as to Management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness,
- (ii) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and
- (iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management’s refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

Question 65

Moon Limited replaced its statutory auditor for the financial year 2020-21. During the course of audit, the new auditor found a credit item of ₹ 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The trade payable had neither approached for the payment nor is he traceable. Under the circumstances no confirmation of the credit balance is available.

Answer

This is a case of external confirmation, covered by SA 505 “External Confirmations”. The identities of trade payables are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of ₹ 5 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company’s financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

Question 66

Write a short note on Situations where external confirmations can be used.

Answer**Situations where external confirmations can be used:**

- (i) Bank balance from bankers
- (ii) Account receivable balances
- (iii) Inventories held by third parties
- (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.

Question 67

Mr. Z who is appointed as auditor of Elite Co. Ltd. wants to use confirmation request as audit evidence during the course of audit. What are the factors to be considered by Mr. Z when designing a confirmation request? Also state the effects of using positive external confirmation request by Mr. Z.

Answer

As per SA 505, "External Confirmation", factors to be considered when designing confirmation requests include:

- (i) The assertions being addressed.
- (ii) Specific identified risks of material misstatement, including fraud risks. The layout and presentation of the confirmation request.
- (iii) Prior experience on the audit or similar engagements.
- (iv) The method of communication (for example, in paper form, or by electronic or other medium).
- (v) Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- (vi) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

Question 68

M/s ABC & Co, LLP are appointed auditors of Sharp Company Ltd. for the year ended 31st March, 2021. As part of the audit process, they want to use confirmation procedures as audit evidence during the course of audit. In view of the fact that positive confirmations are not responded favourably, the firm also intends to use negative confirmation requests. What are the factors to be considered for the same?

Answer

As per SA 505, “External Confirmation”, factors to be considered when designing confirmation requests include:

- (i) The assertions being addressed.
- (ii) Specific identified risks of material misstatement, including fraud risks.
- (iii) The layout and presentation of the confirmation request.
- (iv) Prior experience on the audit or similar engagements.
- (v) The method of communication (for example, in paper form, or by electronic or other medium).
- (vi) Management’s authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorisation.
- (vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

Factors to be considered for Negative Confirmation requests: A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- (1) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate evidence regarding the operating effectiveness of controls relevant to the assertion;
- (2) The population of items subject to negative confirmation procedures comprises a large number of small, homogenous, account balances, transactions or conditions;
- (3) A very low exception rate is expected; and
- (4) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

SA 510 – Initial Audit Engagements-Opening Balances

Question 69

You have been appointed as the auditor of Good Health Ltd. for 2020-21 which was audited by CA Trustworthy in 2019-20. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2019-20 have been brought to account in 2020-21 as Opening Balances and the Opening Balances do not contain misstatements.

Answer

As per SA 510 “Initial Audit Engagements—Opening Balances”, in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- (i) Opening balances contain misstatements that materially affect the current period’s financial statements; and
- (ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Being new assignment audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities some audit evidence can ordinarily be obtained as part of audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks).

Question 70

- (a) What are ‘Initial Audit Engagements’?
- (b) In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of ‘Opening Balances’ to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time.
- (c) If, after performing the procedure, you are not satisfied about the correctness of ‘Opening Balances’; what approach you will adopt in drafting your audit report in two situations mentioned in (b) above?

Answer

(a) Initial Audit Engagement: As per SA 510 “Initial Audit Engagements - Opening Balances”, initial audit engagement is an engagement in which either:

- (i) The financial statements for the prior period were not audited; or
- (ii) The financial statements for the prior period were audited by a predecessor auditor.

(b) (i) Financial Statements Audited by another Auditor – Audit Procedure: If the prior

period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

(ii) Audit of Financial Statements for the First Time – Audit Procedure: When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

(c) Drafting Audit Report: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.

Question 71

In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow, when financial statements are audited for the first time. If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances', what approach you will adopt in drafting your audit report?

Answer

As per SA 510 "Initial Audit Engagements-Opening Balances", the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by -

- (i) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
- (ii) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (iii) By evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could

materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

Approach for drafting Audit Report: If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705 and in case where the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

Question 72

CA. Ashutosh has been appointed as an auditor of Awesome Health Ltd. for the financial year 2020-21 which was audited by CA. Amrawati in 2019-20. As the Auditor of Awesome Health Ltd., state the steps that CA. Ashutosh would take to ensure that the Closing Balances of the financial year 2019-20 have been brought to account in 2020-21 as Opening Balances and the Opening Balances do not contain any misstatements.

Answer

Obtaining sufficient appropriate audit evidence while conducting Initial Audit Engagement: According to SA 510 on "Initial Audit Engagements- Opening Balances", the objective of the Auditor while conducting an initial audit engagement with respect to opening balances is to obtain sufficient appropriate audit evidence so that the-

- (i) opening balances of the preceding period have been correctly brought forward to the current period;
- (ii) opening balances do not contain any misstatement that materially affect the current period's financial statements; and
- (iii) appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Being a new assignment, audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection/ payment of opening accounts receivable/ accounts payable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as property plant and equipment, investments, long term debts, the auditor will examine the records relating to opening balances. The auditor may also be able to get the confirmation from third parties (e.g., balances of long term loan obtained from banks can be confirmed from the Bank Loan statement).

Question 73

CA. Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of

Futura (P) Ltd. for the financial year 2020-21. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA. Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting ₹ 150 lakhs, continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA. Jack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment.

Answer

As per SA 510 “Initial Audit Engagements – Opening Balances”, while conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

- (i) Opening balances contain misstatements that materially affect the current period’s financial statements; and
- (ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements.

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period’s audit procedures, say, the collection of opening accounts receivable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In addition, according to SA 580 “Written Representations”, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management’s judgment or intent in relation to, or the completeness of, a specific assertion. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

In the given case, the management of Futura (P) Ltd. has restrained CA. Jack, its auditor, from obtaining appropriate audit evidence for balances of Accounts Receivable outstanding as it is from the preceding year. CA. Jack, on believing that the preceding year balances have already been audited and on the statement of the management that there are no receipts and credits during the current year, therefore excluded the verification of Accounts Receivable from his audit programme.

Thus, CA. Jack should have requested the management to provide written representation for their views and expressions; and he should also not exclude the audit procedure of closing balances of Accounts Receivable from his audit programme. Consequently, CA. Jack shall also be held guilty for professional misconduct for not exercising due diligence, or grossly negligence in the conduct of his professional duties as per the Code of Ethics.

SA 520 – Analytical Procedures

Question 74

What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?

Answer

As per “SA 520 (Revised) Analytical Procedure”, when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:

- (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
- (ii) Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
- (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
- (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and if analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
 - (1) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and
 - (2) Performing other audit procedures as necessary in the circumstances.

Question 75

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, what are the relevant criteria which determine whether the data is reliable for the purposes of designing substantive analytical procedures?

Answer

Relevant Criteria for Determining Reliability of Data: SA 520 on ‘Analytical Procedures’ provides that the reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.

Accordingly, the following are relevant criteria when determining whether data is reliable for purposes of designing substantive analytical procedures-

- (i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

- (iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

Question 76

In audit of DEF Limited, the Auditor had made use of certain analytical procedures with regard to certain key data in the Statement of Profit and Loss. The results obtained showed inconsistencies with other relevant information. State the course of action that the Auditor should take to ensure that the risk of material misstatement would be contained to a low level fixed as per materiality level.

Answer

Investigating Results of Analytical Procedures: As per SA 520, “Analytical Procedures”, if analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (i) Inquiring of management and obtaining appropriate audit evidence relevant to management’s responses; and
- (ii) Performing other audit procedures as necessary in the circumstances.

Audit evidence relevant to management’s responses may be obtained by evaluating those responses taking into account the auditor’s understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management’s response, is not considered adequate.

Question 77

You have been appointed as an auditor of M/s Excellent Hotels Ltd. As a senior partner, you want to use analytical procedures in respect of room rentals as well as payroll expenses. Discuss.

Answer

Analytical Procedures: As per SA 520 on “Analytical Procedures”, in some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Analytical Procedures in case of Payroll cost- Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

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

SA 530 – Audit Sampling

Question 78

Write a short note on Sampling Risk.

Or

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

Answer

As per SA 530 “Audit Sampling”, the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Question 79

Write short notes on Statistical and Non-Statistical Sampling.

Answer

Statistical and Non-statistical Sampling: Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

As per SA 530, “Audit Sampling”, the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

- (i) **Statistical sampling:** This is a method of audit testing which is more scientific than testing based entirely on the auditor’s own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables’ confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- (ii) **Non-statistical sampling:** Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in

the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

Question 80

Describe the principal methods of selection of samples.

Or

In the course of your audit assignment of Indraprastha Ltd., you want to guide your audit assistants in selecting sample items in such a way that sample can be expected to be representative of the population and all items have an opportunity of being selected. Guide your assistants with principal methods of collecting samples.

Answer

Principle methods of selection of samples: According to SA 530 "Audit Sampling", the principal methods of selecting samples are the use of random selection, systematic selection, monetary unit sampling selection, haphazard selection and block selection. Each of these methods is discussed below-

- (i) **Random selection:** This method is applied through random number generators, for example, random number tables.
- (ii) **Systematic selection:** In this method the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables.
- (iii) **Monetary Unit sampling:** This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- (iv) **Haphazard selection:** In this method 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 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.
- (v) **Block selection:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

SA 540 – Auditing Accounting Estimates, Including Fair Value AE, and Related Disclosures

Question 81

While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?

Answer

As per SA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

- (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
- (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements.
- (iii) In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
- (iv) The estimation making process adopted by the management including-
 - (1) The method, including where applicable the model, used in making the accounting estimates.
 - (2) Relevant controls.
 - (3) Whether management has used an expert?
 - (4) The assumption underlying the accounting estimates.
 - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

Question 82

A Pvt Ltd is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period.

The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise.

Answer

As per SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor’s review takes account of the

nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the management is not correct in refusing the relevant information to the auditor.

Question 83

During the Audit of Data Solutions Ltd., a listed company, your audit manager observed that several estimates are made by the Company. He seeks your guidance to know areas of accounting estimates that may give rise to lower level of risk of material misstatement. Guide him with examples.

Answer

As per **SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

Question 84

With reference to the Standards on Auditing state the examples of accounting estimates that may have a high estimation uncertainty.

Answer

Examples of Accounting Estimates that may have a High Estimation Uncertainty: As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures", the auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.

Question 85

Statutory auditor of O Ltd requested the management for a written representation in respect of obsolescence of inventory and warranty obligations recognized by the company in its financial statements. The management denied the representation on the ground that during the course of audit, all the required procedures were performed by the auditor and after obtaining sufficient appropriate audit evidence, auditor has issued a clean report. Please comment.

Answer

As per SA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures, the auditor shall **obtain written representations** from the management and, where appropriate, those charged with governance whether they believe **significant assumptions used in making accounting estimates are reasonable**.

Depending on the nature, materiality and extent of estimation uncertainty, **written representations** about accounting estimates recognised or disclosed in the financial statements may **include representations**:

- **About the appropriateness of the measurement processes**, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, **and the consistency in application** of the processes.
- That the **assumptions appropriately reflect management's intent and ability** to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates **and disclosures**.
- **That disclosure related to accounting estimates are complete and appropriate** under the applicable financial reporting framework.

- **That no subsequent event requires adjustment** to the accounting estimates and disclosures included in the financial statements.

For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition **or disclosure criteria** of the applicable financial reporting framework **have not been met**.
- The appropriateness of the basis used by management **to overcome the presumption** relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value.

Thus, management's contention on the ground that during the course of audit, all the required procedures were performed by the auditor and after obtaining sufficient appropriate audit evidence, auditor has issued a clean report, **for not providing written representation is not correct. The management should provide written representations to the auditor.**

Further as per SA 580 Written Representation, if management does not provide one or more of the requested **written representations, the auditor shall**

- (a) Discuss the matter with management;**
- (b) Re-evaluate the integrity of management** and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (c) Take appropriate actions, including** determining the possible effect on the opinion in the auditor's report in accordance **with SA 705.**

SA 550 - Related Parties

Question 86

Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18.

Answer

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

- (i) Entity Income Tax Returns.
- (ii) Information supplied by the entity to regulatory authorities.
- (iii) Shareholder registers to identify the entity's principal shareholders.
- (iv) Statements of conflicts of interest from management and those charged with governance.
- (v) Records of the entity's investments and those of its pension plans.
- (vi) Contracts and agreements with key management or those charged with governance.
- (vii) Significant contracts and agreements not in the entity's ordinary course of business.
- (viii) Specific invoices and correspondence from the entity's professional advisors.
- (ix) Life insurance policies acquired by the entity.
- (x) Significant contracts re-negotiated by the entity during the period.
- (xi) Internal auditors' reports.
- (xii) Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).
- (xiii) Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.

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

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

Question 87

In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information.

Answer

As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. However, it is the management, which is primarily responsible for identification of related parties. The duties of an

auditor with regard to reporting of related party transaction as required by Accounting Standard 18 “Related Party Disclosures” is given in SA 550.

- (i) SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity’s principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity’s investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity’s ordinary course of business, specific invoices and correspondence from the entity’s professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors’ reports, documents associated with the entity’s filings with a securities regulator (e.g., prospectuses).
- (ii) Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as an arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the establishment of a business relationship through appropriate vehicles or structures, the conduct of certain types of transactions under specific terms and conditions or the provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include participation in unincorporated partnerships with other parties, agreements for the provision of services to certain parties under terms and conditions that are outside the entity’s normal course of business, guarantees and guarantor relationships etc.

- (iii) Obtaining further information on significant transactions outside the entity’s normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples of transactions outside the entity’s normal course of business may include complex equity transactions, such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged, sales transactions with unusually large discounts or returns, transactions with circular arrangements, for example, sales with a commitment to repurchase, transactions under contracts whose terms are changed before expiry etc.
- (iv) Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties.

Question 88

In the course of your audit you have come across a related party transaction which prima facie appears to be biased. How would you deal with this?

Answer

The duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on, “Related Parties”,

the auditor should review information provided by the management of the entity identifying the names of all known related parties. Since it is the management, which is primarily responsible for identification of related parties, SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions.

In this case, the auditor is finding a related party transaction which prima facie appears to be biased. So the auditor is required to confirm the same. For identified significant related party transactions outside the entity's normal course of business, the auditor shall inspect the underlying contracts or agreements, if any, and evaluate whether:

- (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets,
- (ii) The terms of the transactions are consistent with management's explanations; and
- (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

The auditor should also obtain audit evidence that the transactions have been appropriately authorised and approved.

After obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Finally, the auditor should report on the basis of this fact that the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or they are not cause for the financial statements to be misleading (for compliance frameworks).

Question 89

JY & Co. is appointed as auditor of Breeze Ltd. JY & Co. seeks your guidance for reviewing the records and documentation of the company regarding 'related party transactions in the normal course of business'. Describe the steps to be followed.

Answer

According to SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

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

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

The auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal

shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator etc.

Question 90

You are the Auditor of Power Supply Corporation Limited, a Government Company for the year ended on 31st March 2021. The turnover of the Company for the period was ₹ 12,000 crores from sale of power. During your audit, you found that the Company had procured Spares for Transmitters for ₹ 850 crores from abroad through a Corporation by name Procurement and Supply India Limited which is also owned and controlled by Government of India. The Financial Statements of the Power Supply Corporation Limited, prepared in compliance with Ind AS for the year ended on 31/03/2021 did not contain any additional disclosure regarding the procurement of spares as referred to above. To your query as to whether any disclosure regarding Related Party Transaction would be required, the Management of the Corporation replied that no such disclosure would be necessary for transactions between State Controlled Enterprises.

Analyse this issue in finalizing the Audit Report.

Answer

Related Party Disclosures :As per Ind AS 24, "Related Party Disclosures", a reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with (i) a government that has control or joint control of, or significant influence over, the reporting entity; and (ii) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity.

If a reporting entity applies the above exemption, it shall disclose the following about the transactions and related outstanding balances referred to:

- (1) the name of the government and the nature of its relationship with the reporting entity (i.e. control, joint control or significant influence);
- (2) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:
 - (i) the nature and amount of each individually significant transaction; and
 - (ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

Further, as per SA 550 Related Parties, in forming an opinion on the financial statements in accordance with SA 700, the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

In the instant case, Power Supply Corporation Limited, a Government Company has procured spares for transmitters for rupees 850 crore from abroad through a corporation namely Procurement and Supply India Limited which is also owned and controlled by Government of India. Even after applying the exemption of Ind AS 24, Power Supply Corporation Limited has to disclose the matters specified above (i.e.name of Government, natures of its relationship with reporting entity, the nature and amount of transaction etc.). Contention of Management of Corporation regarding no requirement of disclosure for transactions between State Controlled Enterprise is not tenable.

Question 91

Whilst the Audit team has identified few matters, they need your advice to conclude on the same. Engagement Partner have asked them to review the Board minutes and other secretarial/regulatory records based on which the following additional matters were brought to the attention of the Partner:-

- (i) The long term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.
- (ii) Certain computers were received from the parent company free of cost, the value of which is ₹ 0.23 lac and no accounting or disclosure of the same has been made in the notes to accounts.
- (iii) An amount of ₹ 3.25 Lakhs per month is paid to M/s. WE CARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹0.25 Lakhs per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure of this related party transaction has been made in the notes to accounts forming part of the financial statements highlighting the same as a 'related party' transaction. Audit Manager has reported that she had asked certain information relating to another 'related party' transaction (amounting to approx. ₹47 lac) but the CFO refused to provide the same since the same is perceived to be confidential and cannot be shared with the Auditors.

You are required to advise about items to be reported to those charged with governance, where applicable, based on your audit findings in the given situation.

Answer

As per SA 550, Related Parties, communicating significant matters arising during the audit in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include, non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware; The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud; etc.

It may be noted that unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

The auditor is also required to ensure the compliance of Ind AS 24 / AS 18 Related Party Disclosures.

In view of above in the given scenario, the auditor is required to prepare a brief summary of

following items to be reported to those charged with governance in accordance with SA 260
Communication with Those Charged with Governance:

- (i) One of related party transaction amounting 3.25 lac per month i.e. in lieu of marketing services has been noticed of which amount ₹ 0.25 lac per month is exceeds the arm's length price has not been disclosed highlighting the same as related party transactions as per Ind- AS 24 / AS 18 Related Party Disclosures.
- (ii) Refusal by CFO of the company to provide the details of related party transaction amounting to rupees 47 lac on the ground that same is perceived to be confidential and cannot be shared with auditors, is not in order, as denying for the related part details of ₹ 47 lac is imposing limitation of scope of auditor in view of SA 705.
- (iii) Receipt of free of cost Computers and long-term borrowing (on no agreed terms and repayment of interest and principal) from the Parent Company need separate disclosure in financial statements as per Ind AS 24 / AS 18 Related Party Disclosures.

Further, in case of all the above cases, the auditor would also need to assess his reporting requirements under the clauses (xiii) of Paragraph 3 of CARO 2016 with respect to related party transactions that whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable Accounting Standards.

Question 92

Mr. X, while conducting audit of PQR Ltd, comes across certain transactions which according to him are significant transactions with related parties and identified to be outside the entity's normal course of business. Guide Mr. X with examples of such transactions and to understand the nature of significant transactions outside the entity's normal course of business.

Answer

As per SA 550, Related Parties, **Examples of transactions outside the entity's normal course of business may include:**

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Transactions under contracts whose terms are changed before expiry.

Understanding the nature of significant transactions outside the normal course of business:

Inquiring into the nature of the significant transactions outside the entity's normal course of business involves obtaining an understanding of the business rationale of the transactions, and the terms and conditions under which these have been entered into.

SA 560 – Subsequent Events

Question 93

Briefly describe the auditor's responsibility regarding subsequent events.

Answer

When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realised. SA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. AS 4 on "Contingencies and Events Occurring after the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, two types of events can be identified: (a) those which provide further evidence of conditions that existed at the balance sheet date; and (b) those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

SA 560 further requires that the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Question 94

A fire broke out on 15th May, 2021, in which material worth ₹ 50 lakhs which was lying in inventory since 1st March, 2021 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2021-22, no provision for the loss needs to be made in the financial statements for 2020-21.

Answer

This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

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

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

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

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

Question 95

A Co. Ltd. has not included in the Balance Sheet as on 31-03-2021 a sum of ₹ 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2021. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2021. The auditor came to know the result of the negotiations on 15-05-2021. Comment.

Answer

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

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that

the will occur.

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

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31-3-2021 to the date of Auditors Report i.e. 31-05-2021. It will be observed that as a result of long pending negotiations a sum of ₹ 1.50 cores representing arrears of salaries of the year 2019-20 and 2020-21 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

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

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

Question 96

Amudhan & Co., are the Auditors of XYZ Company Ltd., for the year ended on 31/03/2021. The Audit Report for that year was signed by the Auditors on 04/05/2021. The Annual General Meeting was decided to be held during the month of August 2021. On 06/05/2021, the Company had received a communication from the Central Government that an amount of ₹ 5800 crore kept pending on account of incentives pertaining to Financial Year 2020-21 had been approved and the amount would be paid to the Company before the end of May 2021. To a query to Chief Financial officer of the Company by the Board, it was informed that this amount had not been recognised in the Audited Financial Statements in view of the same not being released before the close of the Financial Year and due to uncertainty of receipt. Now, having received the amount, the Board of Directors wished to include this amount in the Financial Statements of the Company for the Financial Year ended on 31/03/2021. On 08/05/2021, the Board amended the accounts, approved the same and requested the Auditor to consider this event and issue a fresh Audit Report on the Financial Statements for the year ended on 31/03/2021. Analyse the issues involved and give your views as to whether or not the Auditors could accede to the request of the Board of Directors.

Answer

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued: As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

- (i) Discuss the matter with management and, where appropriate, those charged with governance.
- (ii) Determine whether the financial statements need amendment and, if so,
- (iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit

procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

In the instant case, XYZ Company Ltd. received an amount of rupees 5800 crore on account of incentives pertaining to year 2020-21 in the month of May 2021 i.e. after finalisation of financial statements and signing of audit report. Board of Directors of XYZ Ltd. amended the accounts, approved the same and requested the Amudhan & Co. (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2021.

After applying the conditions given in SA 560, Amudhan & Co. can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

Question 97

M/s LMP Associates, Chartered Accountants, while conducting the audit of PQR Ltd want to conduct an inquiry of management and those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. Guide M/s LMP Associates with the matters where specific enquiry may be conducted to evaluate subsequent events.

Answer

Specific Inquiries to Evaluate Subsequent Events: As per SA 560, "Subsequent Events", in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- (i) Whether new commitments, borrowings or guarantees have been entered into.
- (ii) Whether sales or acquisitions of assets have occurred or are planned.
- (iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- (v) Whether there have been any developments regarding contingencies.
- (vi) Whether any unusual accounting adjustments have been made or are contemplated.
- (vii) Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.
- (viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- (ix) Whether any events have occurred that are relevant to the recoverability of assets.

SA 570 - Going Concern

Question 98

ABC Company files a law suit against Unlucky Company for ₹ 5 crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the notes accompanying its financial statements. As an auditor of Unlucky Company, how will you deal with the situation?

Answer

As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

As per SA 570 "Going Concern", there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

In the instant case, ABC Company has filed a law suit against Unlucky Company for ₹ 5 crores. Though, the attorney of Unlucky Company feels that the suit is without merit so the company merely discloses the existence of law suit in the notes accompanying its financial statements. But the auditor may evaluate the source data on which basis the opinion is formed. If the auditor finds the uncertainty, he may request the management to adjust the sum of ₹ 5 crore by making provision for expenses as per AS 29. If the management does not accept the request the auditor should qualify the audit report.

Question 99

A Company's net worth is eroded and trade payables are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders.

Answer

In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 "Going Concern".

Question 100

While examining the going concern assumption of an entity, what important indications should be evaluated and examined?

Answer

SA 570 “Going Concern”, requires that while planning a performing audit procedure and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications-

Financial Indications:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows. Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications:

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other Indications:

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in

claims that the entity is unlikely to be able to satisfy.

- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Question 101

M/s T K Projects Limited, a manufacturing company in the Steel industry was allegedly involved in some irregularity relating to allotment of coal blocks for which a complaint was lodged against the company by the government. The financial institutions stopped additional working capital finance which caused a financial crisis resulting in stoppage of production. The company incurred a massive loss during the year 2020-21. There were delays in salary and other payments. Certain key managerial personnel including GM Finance and certain other employees left the company. The company has no sound action plan to mitigate these situations. Guide the statutory auditor on how he should deal with this situation.

Answer

As per SA 570 on "Going Concern", it is the responsibility of the auditor to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, M/s T K Projects Limited has incurred massive loss during the year 2019-20 as the financial institutions have stopped financing additional working capital to the company because of a complaint which was lodged against the company by government for involvement in some irregularity relating to allotment of coal blocks. There were delays in salary and other payments. Besides this, certain key managerial personnel, GM Finance and certain other employees have also left the company. The company, in addition, has no sound action plan to mitigate these situations.

Thus, there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action to mitigate these factors, the going concern assumption does not seem appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised). But, if the result of the appropriate assumption used in the preparation of financial statements is material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion and in the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Question 102

MNO Limited is one of the prominent players in the chemicals industry. The company is a public company domiciled in India and listed on BSE and NSE. The Company was facing extreme liquidity constraints and there were multiple indicators that casted doubt over the company's ability to continue as a going concern.

The Company was led into insolvency proceedings by consortium of banks led by PNB and the NCLT ordered the commencement of corporate insolvency process against the Company on 31 August 2020. The company invited prospective lenders, investors and others to submit their resolution plans to the Resolution Professional (RP) latest by 1 January 2021. The RP reviewed the resolution plans and ensured conformity with Insolvency and Bankruptcy Code 2016. The compliant plans were presented to Committee on Creditors (CoC) on 2 February 2021 and the resolution plan submitted by PQR Ltd. was evaluated as highest evaluated Compliant Resolution Plan. CoC of MNO Ltd. approved the Resolution Plan submitted by PQR Ltd. on 2 March 2021. The approval of NCLT was finally obtained on 4 May 2021.

PQR Ltd. submitted detailed plans and commitments as part of the resolution plan including clearance of all outstanding debts which were leading to negative cash flows. Please suggest how you would deal with this situation as the auditors of MNO Ltd.

Answer

As per SA 570 Going Concern, if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (hereinafter referred to as "material uncertainty") through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

- (i) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- (ii) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- (iii) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in -
 - (1) Evaluating the reliability of the underlying data generated to prepare the forecast; and
 - (2) Determining whether there is adequate support for the assumptions underlying the forecast.
- (iv) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- (v) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures

about these events or conditions.

In the instant case, the approval of the resolution plan is a significant mitigating factor to counter the going concern issues of MNO Ltd. PQR Ltd. has submitted a detailed plan and commitments that has been given as part of the resolution plan which includes clearance of all outstanding debts which were leading to negative cash flows. Therefore, it can be said that the events and conditions are mitigated effectively and there is no material uncertainty in relation to the ability of the company to continue as a going concern.

Question 103

Toddle Limited had definite plan of its business being closed within a short period from the close of the accounting year ended on 31st March, 2020. The Financial Statements for the year ended 31/03/2021 had been prepared on the same basis as it had been in earlier periods with an additional note that the business of the Company shall cease in near future and the assets shall be disposed off in accordance with a plan of disposal as decided by the Management. The Statutory Auditors of the Company indicated this aspect in Key Audit Matters only by a reference as to a possible cessation of business and making of adjustments, if any, thereto to be made at the time of cessation only. Comment on the reporting by the Statutory Auditor as above.

Answer

Closure of Business: As per SA 570 “Going Concern”, management intentions to liquidate the entity or to cease operations is one of the event or condition that may cast significant doubt on the entity’s ability to continue as going concern.

As per SA 570, if events or conditions have been identified that may cast significant doubt on the entity’s ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

Even when no material uncertainty exists, it requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

Further, as per SA 701 “Communicating Key Audit Matters in the Independent Auditor’s Report”, when matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern is, by its nature, a key audit matter. SA 701 also emphasises on auditor’s responsibility to communicate key audit matters in the auditor’s report.

As per the facts given in the case, intention of the Toddle Limited had definite plan of its business being closed down within short period from 31 March, 2020. However, financial statements for the year ended 31.03.2021 had been prepared on the same basis as it had been in earlier periods with an additional note.

Thus, management intentions to liquidate the entity or to cease operations is one of the event or condition that may cast significant doubt on the entity’s ability to continue as going concern is a key audit matter. Therefore, the auditor is required to Communicate the Key Audit Matters in accordance with SA 570 in above stated manner. Simple reference as to a possible cessation of business and making of adjustments, if any, be made at the time of cessation only by the auditor in his report is not sufficient.

Question 104

M/s Airlift Ltd., carrying on the business of Passenger Transportation by air is running into continuous financial losses as well as reduction in Sales due to stiff competition and frequent break down of its own aircrafts. The Financial Statements for the Year ended on 31/03/2021 are to be now finalized. The Management is quite uncertain as to its ability to continue in near future and has informed the Auditors that having seized of this matter, it had constituted a committee to study this aspect and to give suggestions for recovery, if any, from this bad situation. Till the study is completed, according to the Management, the issue involves uncertainty as to its ability to continue its business and it informs the Auditor that the fact of uncertainty clamping on the "Going Concern" would suitably be disclosed in notes to accounts. State the reporting requirement if any, in the Independent Auditor's Report in respect of this matter.

Answer

Reporting requirements in case of Uncertainty clamping on the Going Concern: As per SA 570 "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements : (i)adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and (ii) disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

- (i) Draw attention to the note in the financial statements that discloses the matters set out above; and
- (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

In the instant case, M/s Aircraft Ltd. is running into continuous financial losses as well as reduction in sales due to stiff competition and frequent break down of its own aircrafts and management of Aircraft Ltd. is uncertain as of its ability to continue in near future. Therefore, a committee has been constituted to study this aspect and till the time study is completed management accordingly decided to suitable disclose this aspect in notes to accounts. Therefore, the auditor should disclose about the material uncertainty and express an unmodified opinion and in his audit report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to draw attention to the note in the financial statements that discloses the matters set out above; and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Question 105

TUV Ltd. is a company engaged in the business of manufacture of spare parts. Saroj & Associates are the statutory auditors of the company for the FY 2020-21. During the course of audit, CA Saroj noticed that the company had a major customer, namely, Korean Mart from South Korea. Owing to an outbreak of war and subsequent destruction leading to government ban on import and export in South Korea, the demand from Korean Mart for the products of TUV Ltd. ended for an unforeseeable time period. When discussed with the management, CA Saroj was told that the company is in the process of identifying new customers for their products. CA Saroj understands that though the use of going concern assumption is appropriate but a material uncertainty exists

with respect to the identification of new customers. This fact is duly reflected in the financial statements of TUV Ltd. for the FY 2020-21. How should CA Saroj deal with this matter in the auditor's report for the FY 2020-21?

Answer

As per SA 570, "Going Concern", loss of a major market or a key customer is one of the operating indicators that may cast significant doubt on the company's ability to continue as a going concern.

In the present case, TUV Ltd. has a key customer in South Korea from which the demand for its products has ended on account of outbreak of war, subsequent destruction and government ban on import and export in South Korea. Further, the company has not yet identified new customers

and is in the process of doing the same. As such, the identification of new customer is a material uncertainty that cast a significant doubt on the company's ability to continue as a going concern.

However, this matter is duly disclosed by the management of TUV Ltd. in the financial statements for the year ended 31.03.2021.

As such, considering that the going concern assumption is appropriate but a material uncertainty exists with respect to identification of new customer, CA Saroj should:

- (1) Express an unmodified opinion and
- (2) Include in his audit report, a separate section under the heading "Material Uncertainty Related to Going Concern" to:
 - (i) Draw attention to the note in the financial statements that discloses the matters and
 - (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Thus, CA Saroj should deal with this matter in his auditor's report in the above mentioned manner.

Question 106

Sun Moon Ltd. is a power generating company which uses coal as raw material for its power generating plant. The company has been allotted coal blocks in the state of Jharkhand and Odhisa. During the FY 2020-21, a scam regarding allotment of coal blocks was unveiled leading to a ban on the allotment of coal blocks to various companies including Sun Moon Ltd. This happened in the month of December 2020 and as such entire power generation process of Sun Moon Ltd, came to a halt in that month. As a result of such ban, and the resultant stoppage of the production process, many key managerial personnel of the company left the company. There were delays in the of payment of wages and salaries and the banks from whom the company had taken funds for project financing also decided not to extend further finance or to fund further working capital requirements of the company.

Further, when discussed with the management, the statutory auditor understood that the company had no action plan to mitigate such circumstances. Further, all such circumstances were not reflected the financial statements of Sun Moon Ltd. What course of action should the statutory auditor of the company consider in such situation?

Answer

SA 570- "Going Concern" deals with the auditor's responsibilities in the audit of financial

statements relating to going concern and the implications for the auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

When the use of Going Concern Basis of Accounting Is Inappropriate i.e. if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

Also when adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements the auditor shall:

- (i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and
- (ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the present case, the following circumstances indicate the inability of Sun Moon Ltd. to continue as a going concern:

- Ban on the allotment of coal blocks
- Halt in power generation
- Key Managerial Personnel leaving the company.
- Banks decided not to extend further finance and not to fund the working capital requirements of the company.
- Non availability of sound action plan to mitigate such circumstances.

Therefore, considering the above factors it is clear that the going concern basis is inappropriate for the company. Further, such circumstances are not reflected in the financial statements of the company. As such, the statutory auditor of Sun Moon Ltd. should:

- (1). Express an adverse opinion in accordance with SA 705 (Revised) and
- (2). In the Basis of Opinion paragraph of the auditor's report, the statutory auditor should state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

SA 580 - Written Representations

Question 107

Explain what is meant by “Written Representations” and indicate to what extent an auditor can place reliance on such representations.

Answer

A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Thus written representations are necessary information that the auditor requires in connection with the audit of the entity’s financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management’s responsibilities, or about specific assertions.

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

Extent of Reliance: SA 580, “Written Representations”, states that If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor’s report.

Question 108

State briefly the basic elements of Management Representation Letter.

Answer

As per SA 580 “Written Representations”, some of the basic elements of a Management Representation letter are-

(1) It is a written statement by management provided to the auditor to confirm certain matters or

to support other audit evidence.

- (2) It does not include financial statements, assertions therein, or supporting books and records.
- (3) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.
- (4) The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Question 109

In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?

Answer

As per SA 580 "Written Representations", if the management does not provide one or more of the requested written representations, the auditor shall:

- (i) Discuss the matter with management,
- (ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general, and
- (iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor should disclaim an opinion on the financial statements if management does not provide written representations in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

Question 110

An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

Answer

The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Sagar Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry.

As per SA 580 "Written Representations", when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence from other sources inside or outside the entity.

He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Written Representations" cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available.

If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by the auditor is not right.

Question 111

PRSH & Co is the statutory auditor of Make My Journey Ltd. The company is in the business of tours and travels. Annual turnover of the company is INR 2000 crores and profits are INR 190 crores. During the planning meeting of the management and the auditors, it was discussed that the management needs to provide written representation letter to the auditors for the preparation of the financial statements and for the completeness of the information provided to the auditor. At the time of closure of the audit, there has been some confusion about the requirements of the written representation letter. Management argued that representation need not be written, it can also be verbal which has been provided to the audit team during the course of their audit. Auditors have completed their documentation and hence in a way, representation based on verbal discussions with the auditors has also got documented. Auditors explained that this is mandatory to obtain written representation in accordance with the requirements of SA 580. However, still some confusion remains regarding the date and period covered by the written representation. You are required to advise about the date of and period covered by written representation in view of SA 580.

Answer

As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Question 112

Mr. L while conducting the audit of ABC Ltd., observed that a substantial amount is recognized in respect of obsolescence of inventory and warranty obligation in the financial statements. Mr. L wants to obtain written representation from the management to determine whether the assumptions and estimates used are reasonable. Guide Mr. L with reference to the relevant Standard on Auditing.

Answer

Written Representations: As per SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

SA 580, “Written Representations” discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- (i) About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- (ii) That the assumptions appropriately reflect management’s intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- (iii) That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- (iv) That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

SA 600 – Using the Work of Another Auditor

Question 113

“There should be sufficient liaison between a principal auditor and other auditors”. Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor.

Answer

SA 600 on “Using the Work of Another Auditor” lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor’s immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor’s work.

When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report.

Question 114

B is the Principal Auditor of ABC Co. Ltd., with 8 branches audited by 8 Branch Auditors. B wanted to ensure that the works of Branch Auditors were adequate for the purpose of his audit. Hence he insisted on Branch Auditors to get familiar with a check list he prepared for branches and, besides, required them to share the working papers compiled by them for his review and return. Is Principal Auditor within his right in asking for such sharing of working papers?

Answer

Using the Work of Another Auditor: When the accounts of the branch are audited by a person other than the company’s auditor, there is need for a clear understanding of the role of such auditor and the company’s auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the

Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (1) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
- (2) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Further, SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel."

In the light of aforesaid, principal auditor was not within his right for asking for such sharing of working papers. It depends upon the discretion of auditor.

Question 115

B Ltd is the Subsidiary company of A Ltd. ABC & Associates has been appointed as auditor of A Ltd. for the Financial Year 2020-21 and XYZ & Associates has been appointed as auditor of B Ltd for the year 2020-21. Explain the role of ABC & Associates and XYZ & Associates as auditors of the parent company and subsidiary respectively.

Answer

Role of Auditor in case of Parent Company and Subsidiary Company: As per SA 600 "Using the Work of Another Auditor", there should be sufficient liaison between the principal auditor (hereinafter referred as auditor of Parent Company and the other auditor (hereinafter referred as auditor of Subsidiary Company).

Role of Principal Auditor (ABC & Associates- Auditor of Parent Company):

- (i) It is necessary to issue written communication(s) as a principal auditor to the other auditor.
- (ii) The principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.
- (iii) When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties.

Role of Other Auditor (XYZ & Associates- Auditor of Subsidiary Company):

- (i) The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc.
- (ii) He should ensure compliance with the relevant statutory requirements.
- (iii) The other auditor should respond to the questionnaire on a timely basis sent by Principal Auditor.

SA 610 – Using the Work of Internal Auditors

Question 116

CA. Amboj, a practicing chartered accountant has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA. Kishor, the statutory auditor of the Company, for his view and reporting. Can CA. Kishor rely on such report?

Answer

As per SA 610 “Using the Work of Internal Auditors”, while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

- (a) The extent to which the internal audit function’s organizational status and relevant policies and procedures support the objectivity of the internal auditors;
- (b) The level of competence of the internal audit function; and
- (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

- (a) The function’s organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- (b) The function lacks sufficient competence; or
- (c) The function does not apply a systematic and disciplined approach, including quality control.

In the instant case, CA. Kishor should ascertain the internal auditor’s scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

Question 117

OPQ Ltd is in the business of software consultancy. The company has had large balances of accounts receivables in the past years which have been assessed as area of high risk. For the year ended 31 March 2021, in respect of the valuation of accounts receivable, the statutory auditor has assigned the checking of the accuracy of the aging of the accounts receivables and provision based on ageing to the internal auditor providing direct assistance to him. Please advise.

Answer

As per SA 610 Using the Work of Internal Auditor, the external auditor (Statutory Auditor) shall not use internal auditors to provide direct assistance to perform procedures that:

- (a) Involve making significant judgments in the audit;
- (b) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;

- (c) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- (d) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

In the given case where the valuation of accounts receivable is assessed as an area of higher risk, the statutory auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

Question 118

Mr. Anand is appointed as statutory auditor of XYZ Ltd. XYZ Ltd is required to appoint internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. Bhola as its internal auditor. The external auditor Mr. Anand asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.

- (a) Discuss whether Mr. Anand, statutory auditor, can ask direct assistance from Mr. Bhola, internal auditor as stated above in view of Standards on Auditing.
- (b) Will your answer be different, if Mr. Anand ask direct assistance from Mr. Bhola, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?

Answer

- (a) **Direct Assistance from Internal Auditor:** As per SA 610 “Using the Work of Internal Auditor”, the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management’s use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor’s report.

In view of above, Mr. Anand cannot ask direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

- (b) **Direct Assistance from Internal Auditor in case of External Confirmation Procedures:** SA 610 “Using the Work of Internal Auditor”, provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Further, in accordance with SA 505, “External Confirmation” the external auditor is

required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

SA 620 – Using the Work of an Auditor’s Expert

Question 119

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct auditing for the financial year 2020-21. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuary reports. However, Mr. X agreed to Mr. Y’s actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y’s actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma.

Explain the responsibility of auditors, in case, report made by Mr. Y’s actuary, later on, found faulty.

Answer

As per SA 620 “Using the Work of an Auditor’s Expert”, the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans etc., however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor’s use of the work of an auditor’s expert.

The auditor shall evaluate the adequacy of the auditor’s expert’s work for the auditor’s purposes, including the relevance and reasonableness of that expert’s findings or conclusions, and their consistency with other audit evidence as per SA 500.

Further, in view of SA 620, if the expert’s work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert’s work involves the use of source data that is significant to that expert’s work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. X, Mr. Y and Mr. Z, jointly appointed as an auditor of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor’s expert as per SA 620. Mr. Y’s referred actuary has provided the gratuity valuation report, which later on found faulty. Further, Mr. Z is not agreed with this report therefore he submitted a separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. X, Mr. Y and Mr. Z, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. X and Mr. Y will be held responsible for grossly negligence and using such faulty report without examining the adequacy of expert actuary’s work whereas Mr. Z will not be held liable for the same due to separate opinion expressed by him.

Question 120

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

Answer

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

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

- (i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- (ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- (iii) The estimation of oil and gas reserves.
- (iv) The valuation of environmental liabilities, and site clean-up costs.
- (v) The interpretation of contracts, laws and regulations.
- (vi) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor’s expert’s work, including the relevance and reasonableness of that expert’s findings or conclusions, and their consistency with other audit evidence; if that expert’s work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert’s work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor’s expert is not adequate for the auditor’s purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

Question 121

X Ltd had a net worth of INR 1300 crores because of which Ind AS became applicable to them. The company had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor’s expert to audit valuation of derivatives. Auditor and auditor’s expert were new to each other i.e. they were working for the first time together but developed a good bonding during the course of the audit. The auditor did not enter into any formal agreement with the auditor’s expert. Please advise.

Answer

As per SA 620, Using the work of an Auditor’s Expert, the nature, scope and objectives of the auditor’s expert’s work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor’s expert, and the nature, timing and extent of communication between the auditor and the auditor’s expert. It is therefore required that these matters are agreed between the auditor and the auditor’s expert.

In certain situations, the need for a detailed agreement in writing is required like -

- The auditor’s expert will have access to sensitive or confidential entity information.
- The matter to which the auditor’s expert’s work relates is highly complex.
- The auditor has not previously used work performed by that expert.

- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

In the given case, considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

Question 122

CA Dabu has been appointed as an auditor of M/s MAP Technocraft Ltd. to conduct statutory audit. While conducting audit, he came across some difficulties which the management could not explain to him properly and, therefore, he decided to take services of Mr. Jay, an engineering consultant. Mr. Jay performed his work and submitted details to CA Dabu. State the specific procedure which CA Dabu should follow to evaluate the adequacy of work performed by Mr. Jay.

Or

State what may be the evaluative or review procedures that the Statutory Auditor may do before concluding as to relevance and reasonableness of Auditor's Expert work for using it for his audit purposes.

Answer

Evaluating the Adequacy of the Auditor's Expert's Work: As per SA 620 Using the work of an Auditor's Expert, the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence, etc.

Specific procedure to evaluate the adequacy of the auditor's expert's work are –

- Enquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports
- Corroborative procedure such as-
 - (a) Observing the auditor's expert's work
 - (b) Examining the published data, such as statistical reports from reputed source
 - (c) Confirming the relevant matters with third parties
 - (d) Performing detailed analytical procedure to see whether principles of materiality aspects considered
 - (e) Re performing calculations
- Discussions with another expert with relevant expertise when, for example, the findings or the conclusion of the auditor's expert are not consistent with other audit evidence.
- Discussing the expert's report with the management.

Therefore, as per SA 620 on "Using the Work of an Auditor's Expert", the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

- (i) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;
- (ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and
- (iii) If that expert's work involves the use of source data that is significant to that expert's work,

the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

- (i) Agree with that expert on the nature and extent of further work to be performed by that expert; or
- (ii) Perform further audit procedures appropriate to the circumstances.

Question 123

Mr. Mohan, an auditor of K TEN Limited wants to use the work of an expert. With reference to the Standard on Auditing state the factors which suggest the need for detailed and written agreement between the auditor and the auditor's expert.

Answer

As per SA 620, "Using the work of an Auditor's Expert", some of the matters may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:

- The auditor's expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

SA 700 - Forming an Opinion and Reporting on Financial Statements

Question 124

Enumerate the 'Basic Elements of Audit Report' as enshrined in SA 700.

Answer

As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements:

1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.
2. **Addressee:** The auditor's report shall be addressed as required by the circumstances of the engagement.
3. **Auditor's Opinion:** The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
 - (b) State that the financial statements have been audited;
 - (c) Identify the title of each statement comprising the financial statements;
 - (d) Refer to the notes, including the summary of significant accounting policies; and
 - (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.
4. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:
 - (a) States that the audit was conducted in accordance with Standards on Auditing;
 - (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
 - (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI;
 - (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
 5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570
 6. **Key Audit Matters:** For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701.
When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.
 7. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance.
 8. **Auditor's Responsibilities for the Audit of the Financial Statements.**
 9. **Location of the description of the auditor's responsibilities for the audit of financial**

statements.

10. Other Reporting Responsibilities.

11. Signature of the Auditor.

Question 125

KPI Ltd. is a company on which International Standards on Auditing are applicable along with Standard on Auditing issued by the ICAI. The company appointed new auditors for the audit of the financial statements year ended 31 March 2021 after doing all appointment formalities. Therefore, the auditor's report referred the International Standard on Auditing in addition to the Standard on Auditing issued by the ICAI.

As an expert, you are required to advise the auditor regarding auditor's report for audits conducted in accordance with both the Standards.

Answer

Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction:

As per SA 700, "Forming an Opinion and Reporting on Financial Statements", an auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

- (a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:
 - (i) to form a different opinion, or
 - (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and**
- (b) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

SA 701 – Communicating Key Audit Matters in the Independent Auditor’s Report

Question 126

Write a short note on the purpose of communicating key audit matters.

Answer

The purpose of communicating key audit matters is to enhance the communicative value of the auditor’s report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements (“intended users”) to assist them in understanding those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

Question 127

As an auditor of a listed company for the year ended 31st March, 2020, how would you determine the 'Key Audit Matters'?

Answer

As per SA 701, “Communicating Key Audit Matters in the Independent Auditor’s Report”, the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- (i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment”.
- (ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (iii) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

Question 128

CA. Amar has come across certain key matters while auditing the accounts of PR Ltd. for the financial year 2017-18. He, being the associate of your firm, seeks your advice on "Communicating Key Audit Matters" in the Auditor's Report. Guide him.

Answer

Communicating Key Audit Matters in the Auditor's Report: The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:

- (i) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- (ii) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

- (i) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and
- (ii) How the matter was addressed in the audit.

The auditor shall describe each key audit matter in the auditor's report unless:

- (i) Law or regulation precludes public disclosure about the matter; or
- (ii) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter.

SA 705 – Modifications to the Opinion in the Independent Auditor’s Report

Question 129

What are the professional obligations of the auditor who has withdrawn from the audit before completion of his term due to non co-operation of the Management in completing certain audit procedures?

Answer

SA 705 “Modifications to the Opinion in the Independent Auditor’s Report” provides the consequence of an inability to obtain sufficient appropriate audit evidence due to a management – imposed limitation after the auditor has accepted the engagement.

The practicability of withdrawn from the audit may depend upon the stage of completion of the engagement at the time that management imposes the scope limitation.

When the auditor concludes that withdrawn from the audit is necessary because of a scope limitation, there may be a professional, regulatory or legal requirement for the auditor to communicate matters relating to the resignation from the engagement to regulators or the entity’s owners.

In the case of resignation from the company, provisions of the Companies Act, 2013 applies. Section 140(2) of the Companies Act, 2013, requires the auditor, who has resigned from the company, to file within a period of 30 days from the date of resignation, a statement with the company and the registrar, and in case of government companies, the auditor shall file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor will be liable for penal provisions.

Question 130

Under the applicable Standards on Auditing, in what circumstances does the report of the statutory auditor require modifications? What are the types of modifications possible to the said report?

Answer

Modifications in Audit Report: As per SA 705, “Modifications to the Opinion in the Independent Auditor’s Report”, the auditor shall modify the opinion in the auditor’s report when:

- (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

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

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

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

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

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Question 131

ADKS & Co LLP are the newly appointed statutory auditors of PKK Ltd. During the course of audit, the statutory auditors have come across certain significant observations which they believe could lead to material misstatement of financial statements. Management has a different view and does not concur with the view of the statutory auditors. Considering this the statutory auditors are determining as to how to address these observations in terms of their reporting requirement. Please advise.

Answer

As per SA 705, if the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in his report.

The auditor in such a case needs to determine the modification as follows:

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

- (iii) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

Question 132

CA Omkar is the statutory auditor of Sabhyata Ltd. for the FY 2020-21. The company is engaged in the business of manufacture of floor tiles. During the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Discuss as to how CA Omkar should deal with the situation in the auditor's report.

Answer

SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

In the present case, during the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Therefore, CA Omkar should modify his report in accordance with SA 705- "Modifications to the Opinion in the Independent Auditor's Report.

CA Omkar should issue either a qualified opinion or an adverse opinion depending upon the circumstances of the case:

- (a) CA Omkar shall express a qualified opinion when, having obtained sufficient appropriate audit evidence, he concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements
- (b) CA Omkar shall express an adverse opinion, when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Thus, since CA Omkar has obtained audit evidence which are inconsistent with the affirmations made in the financial statement, CA Omkar should modify his opinion as per the circumstances of the case.

SA 706 - Emphasis of Matter Paragraphs & Other Matter Paragraphs in Independent Auditor's Report

Question 133

Write a short note on Emphasis of matter paragraph in Audit Reports.

Answer

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 modification 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.

SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

Specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor's report in certain circumstances. These circumstances include:

- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- To alert users that the financial statements are prepared in accordance with a special purpose framework.
- When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.¹
- Early application (where permitted) of a new accounting standard that has a material effect on

the financial statements.

- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

SA 710 – Comparative Information – Corresponding Figures and Comparative Financial Statements

Question 134

Write a short note on Auditor's responsibilities regarding comparatives.

Answer

SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 (Revised).

As required by SA 580 (Revised), the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

Question 135

Write a short note on Corresponding figures.

Answer

As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", "corresponding figures" is a comparative information where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period. These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be

read only in relationship to the current period figures.

Question 136

What are the auditor's responsibilities in respect of corresponding figures?

Answer

As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 "Subsequent Events".

As required by SA 580, "Written Representations", the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

Question 137

The audit report of P Ltd. for the year 2019-20 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2020-21, how would you report, if:

- (i) The company does not make provision for doubtful debts in 2020-21?
- (ii) The company makes adequate provision for doubtful debts in 2020-21?

Answer

Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included

a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Question 138

It was observed from the modified audit report of the financial statements of ULFA Ltd. for the year ended 31st March, 2020 that depreciation of ₹ 4.25 crore for the year 2019-20 had been charged off to the Statement of Profit and Loss instead of including it in "carrying value of asset under construction". State in relation to the audit for the year ended 31st March 2021, whether such modification in the previous year's audit report would have any audit implication for the current year i.e. FY 2020-21 and if yes, how the auditor is required to deal with the same in his audit report for the current year?

Answer

Auditor's responsibility in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements".

As per SA 710, when the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant case, if ULFA Ltd. does not correct the treatment of depreciation to the extent of rupees 4.25 crore for previous year, the auditor will have to modify his report for both current

and previous year's figures as mentioned above. If, however, the figures and provisions are corrected, the auditor need not consider to the earlier year's modification.

SA 720 - The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

Question 139

LMP Associates, Chartered Accountants, conducting the audit of PQR Ltd., a listed Company for the year ended 31st March 2021 is concerned with the auditor's responsibilities relating to other information, both financial and non-financial, included in the Company's annual report. While reading other information, LMP Associates considers whether there is a material inconsistency between other information and the financial statements. As a basis for the consideration the auditor shall evaluate their consistency, compare selected amounts or other items in the other information with such amounts or other items in the financial statements. Guide LMP Associates with examples of "Amounts" or "other items" that may be included in the "other information" with reference to SA 720.

Answer

Examples of Amounts or Other Items that May Be Included in the Other Information: As per SA 720 "The Auditor's Responsibility in Relation to Other Information", the following are examples of amounts and other items that may be included in other information. This list is not intended to be exhaustive.

Amounts

- (i) Items in a summary of key financial results, such as net income, earnings per share, dividends, sales and other operating revenues, and purchases and operating expenses.
- (ii) Selected operating data, such as income from continuing operations by major operating area, or sales by geographical segment or product line.
- (iii) Special items, such as asset dispositions, litigation provisions, asset impairments, tax adjustments, environmental remediation provisions, and restructuring and reorganization expenses.
- (iv) Liquidity and capital resource information, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations.
- (v) Capital expenditures by segment or division.
- (vi) Amounts involved in, and related financial effects of, off-balance sheet arrangements.
- (vii) Amounts involved in guarantees, contractual obligations, legal or environmental claims, and other contingencies.
- (viii) Financial measures or ratios, such as gross margin, return on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and debt ratio. Some of these may be directly reconcilable to the financial statements.

Other Items

- (i) Explanations of critical accounting estimates and related assumptions.
- (ii) Identification of related parties and descriptions of transactions with them.
- (iii) Articulation of the entity's policies or approach to manage commodity, foreign exchange or interest rate risks, such as through the use of forward contracts, interest rate swaps, or other financial instruments.

- (iv) Descriptions of the nature of off-balance sheet arrangements.
- (v) Descriptions of guarantees, indemnifications, contractual obligations, litigation or environmental liability cases, and other contingencies, including management's qualitative assessments of the entity's related exposures.
- (vi) Descriptions of changes in legal or regulatory requirements, such as new tax or environmental regulations, that have materially impacted the entity's operations or fiscal position, or will have a material impact on the entity's future financial prospects.
- (vii) Management's qualitative assessments of the impacts of new financial reporting standards that have come into effect during the period, or will come into effect in the following period, on the entity's financial results, financial position and cash flows.
- (viii) General descriptions of the business environment and outlook.
- (ix) Overview of strategy.
- (x) Descriptions of trends in market prices of key commodities or raw materials.
- (xi) Contrasts of supply, demand and regulatory circumstances between geographic regions.
- (xii) Explanations of specific factors influencing the entity's profitability in specific segments.

Question 140

ING Associates, Chartered Accountants, conducting the audit of XYZ Ltd., a listed Company for the year ended 31st March 2021 is concerned with the auditor's responsibilities relating to misstatements in other information, both financial and non-financial, included in the Company's annual report. While reading other information, ING Associates considers whether there is any material misstatement of the other information in the Company. After performing their procedures, the auditor concludes that a material misstatement of the other information exists. ING Associates discussed with the Management about the other information that appeared to be materially misstated to the auditor and also requested management to provide evidence for the basis of management's statements in the other information along with supporting documents. Guide ING Associates as to how to respond to that material misstatement of other information obtained prior to the date of auditor's report. Will your answer be different in case ING Associates conclude the same after the date of auditor's report?

Answer

Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists: As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

- (i) Agrees to make the correction, the auditor shall determine that the correction has been made; or
- (ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor shall take appropriate action, including:

- (i) Considering the implications for the auditor's report and communicating with those charged

with governance about how the auditor plans to address the material misstatement in the auditor's report;

- (ii) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

If the auditor concludes that a material misstatement exists in other information obtained **after the date of the auditor's report**, the auditor shall:

- (i) If the other information is corrected, perform the procedures necessary in the circumstances; or
- (ii) If the other information is not corrected after communicating with those charged with governance, take appropriate action considering the auditor's legal rights and obligations, to seek to have the uncorrected material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared.

CHAPTER - 2

Audit Planning, Strategy & Execution

Question 1

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting. Explain.

Answer

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting.

- 1. Execution Planning:** Prior to commencement of an audit engagement, it is important to lay down the roadmap for audit execution to ensure timely and quality audit results. The auditors need to plan their work in order to carry out the audit in an effective, efficient and timely manner. A detailed audit program is prepared laying down the audit objectives, scope and audit approach. The manpower requirement, audit team qualifications, and the time element, etc. are some of the important considerations during execution planning. In order to plan effectively, the auditor may need some more information about the audit area. A preliminary survey would help in gathering the required information.
- 2. Risk and Control Evaluation:** For each segment of audit, the auditors should conduct a detailed risk and control assessment i.e. list the risks that must be reviewed in that segment, capture for each risk the controls that exist or those that are needed to protect against the risk and show for each control, the work steps required to test the effectiveness of the controls. While making Risk & Control assessment it is necessary to borne in mind Materiality levels as the same is linked with Audit Risks.
- 3. Testing:** Once a comprehensive understanding is gained of the key risks and the controls to be evaluated in a given audit area, the auditors should test the operating effectiveness of the controls to determine whether controls are operating as designed. There are multiple test methods which can be used to arrive at the conclusions on the effectiveness of the controls
- 4. Reporting:** SA 700, "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements such as compliance of Provisions & Enactments of the Company Law, Accounting Standards framed by ICAI, latest Guidelines etc.

The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report.

- 5. Other Important Considerations:** In addition to above, there are certain other consideration which auditor is required to take care while executing the audit such as using the work of other auditor, using the work of an auditor's expert etc.

Question 2

Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. Its other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises.

Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are, therefore, required to draw an audit programme initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points relating to a complex.

Answer

Audit Programme of Movie Theatre Complex:

- (i) Peruse the **Memorandum of Association and Articles** of Association of the entity.
- (ii) Ensure the **object clause** permits the entity to engage in this type of business.
- (iii) In the case of income from sale of tickets:
 - (1) Verify the **control system** as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
 - (2) Verify the system of relating to **online booking** of various shows and the system of realization of money.
 - (3) Check that there is **overall system of reconciliation of collections** with the number of seats available for different shows on a day.
- (iv) Verify the **internal control system** and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.
- (v) Verify the system of control exercised relating to the **income receivable from advertisements** exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
- (vi) Verify the system of collection from the **parking areas** in respect of the vehicles parked by the customers.
- (vii) In the case of **payment to the distributors** verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
- (viii) Verify the system **of payment of salaries and other benefits to the employees** and ensure that statutory requirements are complied with.
- (ix) Verify the payments effected in respect of the **maintenance of the building** and ensure the same is in order.
- (x) Verify the **insurance premium paid** and ensure it covers the entire assets.

Question 3

A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?

Answer

Development of an overall plan - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit:

- (i) **Terms** of his engagement and any statutory responsibilities.
- (ii) Nature and **timing of reports** or other communications.
- (iii) Applicable **Legal or Statutory requirements**.
- (iv) **Accounting policies** adopted by the clients and changes, if any, in those policies.
- (v) The effects of new **accounting and auditing pronouncement** on the audit.
- (vi) Identification of **significant audit areas**.
- (vii) Setting of **materiality levels** for the audit purpose.
- (viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- (ix) **Degree of reliance** to be placed on the accounting system and internal control.
- (x) Possible rotation of emphasis on specific audit areas.
- (xi) Nature and extent of **audit evidence** to be obtained.
- (xii) Work of the **internal auditors** and the extent of reliance on their work, if any in the audit.
- (xiii) **Involvement of other auditors** in the audit of subsidiaries or branches of the client and involvement of experts.
- (xiv) Allocation of works to be undertaken between **joint auditors** and the procedures for its control and review.
- (xv) Establishing and coordinating **staffing requirements**.

Question 4

As an auditor of garment manufacturing company for the last five years, you have observed that new venture of online shopping has been added by the company during current year. What factors would be considered by you in formulating the audit strategy of the company?

Answer

Formulation of Audit Strategy: While formulating the audit strategy for a company, following factors may be considered -

General Factors:

- (i) **Determination of Characteristics of Audit:** Identify the characteristics of the engagement that define its scope.
- (ii) **Reporting Objectives:** Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.

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- (iii) **Team's Efforts:** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- (iv) **Preliminary Work:** Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.
- (v) **Nature, timing and Extent of Resources:** Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Specific Factors for Online Shopping:

The auditor shall also obtain an understanding of the information system including the related business processes due to new venture of online shopping in the following areas:

- (i) The **classes of transactions** in the entity's operations that are significant to the financial statements;
- (ii) The **procedures, within both information technology (IT) and manual systems**, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (iii) The related **accounting records**, supporting information and specific accounts **in the financial statements** that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- (iv) How the **information system captures events and conditions**, other than transactions, that are significant to the financial statements;
- (v) **Controls surrounding journal entries**, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Question 5

BSA & Company, Chartered Accountants are duly appointed auditors of ASB LTD engaged in manufacturing of various FMCG products and having its manufacturing facilities spread across India. Senior partner CA B has called meeting of audit staff to plan the conduct of audit for the year 2019-20 and at the meeting he addresses as under:

"SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing", states that to achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit. Without a careful plan, the overall objective of an audit may not be achieved. The audit planning is necessary to conduct an effective audit in an efficient and timely manner".

In view of above, you are required to analyse and explain the benefits of Planning in an Audit of Financial Statements.

Answer

SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" states that to achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit. Without a careful plan, the overall objective of an audit may not be achieved. The audit planning is necessary to conduct an effective audit in an efficient and timely manner.

Benefits/Advantages of Planning in an Audit of Financial Statements

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Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways described hereunder-

- (i) **Attention to Important Areas** - Planning would help the auditor to devote appropriate attention to important areas of the audit.
- (ii) **Timely resolution of Potential Problems** - It would also help the auditor identify and resolve potential problems on a timely basis.
- (iii) **Proper Organisation and Management of Audit Engagement** - Adequate planning would help the auditor in properly organizing and managing the audit engagement so that it is performed in an effective and efficient manner.
- (iv) **Proper Selection of Engagement Team** - Planning would assist the auditor in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- (v) **Direction and Supervision of Engagement Team** - It would further facilitate the direction and supervision of engagement team members and the review of their work.
- (vi) **Easy Coordination** - Also, planning would be helpful to the auditor in coordination of work done by auditors of components and experts.

Question 6

“Planning is not a discrete phase of an audit but rather a continual and iterative process.” Analyse explaining the matters to be considered while planning an audit.

Answer

Planning is not a discrete phase of an audit but rather a continual and iterative process. It often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes consideration of the timing of certain activities and audit procedures.

For example, planning includes the need to consider such matters as:

- The **analytical procedures** to be applied as risk assessment procedures.
- Obtaining a general understanding of the **legal and regulatory framework** applicable to the entity and how the entity is complying with that framework.
- The determination of **materiality**.
- The involvement of **experts**.
- The performance of **other risk assessment procedures**.

Question 7

“The auditor shall document (i) The overall audit strategy; (ii) The audit plan; and (iii) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.” Explain.

Answer

Documenting the Audit Plan

The auditor shall document-

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- (i) The **overall audit strategy**;
- (ii) The **audit plan**; and
- (iii) **Any significant changes** made during the audit engagement to the overall audit strategy or the audit plan, **and the reasons for such changes** as under -
 - (a) **Record of Key Decisions:** The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.
 - (b) **Record of Nature: Timing and Extent of Risk Assessment Procedures:** The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.
 - (c) **Record of reasons for Change in Audit Plans:** A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Question 8

You have been appointed as auditor of Bahubali Ltd. for the first time. Enumerate the factors to be considered while establishing an overall audit strategy and its benefits.

Answer

Factors while establishing Overall Audit Strategy: Overall audit strategy would involve-

- (i) **Determination of Characteristics of Audit:** Identify the characteristics of the engagement that define its scope.
- (ii) **Reporting Objectives:** Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.
- (iii) **Team's Efforts:** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- (iv) **Preliminary Work:** Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant.
- (v) **Nature, timing and Resources:** Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Benefits of Overall Audit Strategy: The process of establishing the overall audit strategy assists the auditor to determine such matters as-

- (i) **Employment of Qualitative Resources:** The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters.
- (ii) **Allocation of Quantity of Resources:** The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at

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material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.

- (iii) **Timing of Deployment of Resources:** When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates.
- (iv) **Management of Resources:** How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

Question 9

Write a short note on Contents of an audit plan

Answer

Contents of an Audit Plan: The auditor shall develop an audit plan that shall include a description of-

- (i) The **nature, timing and extent of planned risk assessment procedures, as determined under SA 315** "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
- (ii) The nature, timing and extent of planned **further audit procedures at the assertion level, as determined under SA 330** "The Auditor's Responses to Assessed Risks".
- (iii) **Other planned audit procedures** that are required to be carried out so that the engagement complies with SAs.

The **audit plan is more detailed than the overall audit strategy** that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the **auditor may begin the execution of further audit procedures** for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Question 10

Discuss the relationship between overall audit strategy and audit plan.

Answer

Relationship between the Overall Audit Strategy and the Audit Plan:

- The **audit strategy provides the guidelines for developing the audit plan**. It establishes the scope and conduct of the audit procedures and thereby works as basis for developing a detailed audit plan.
- Detailed audit plan would include the **nature, timing and extent** of the audit procedures to obtain sufficient appropriate audit evidence.
- The audit strategy is **prepared before the audit plan**.
- The **audit plan contains more details** than the overall audit strategy.

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- Audit strategy and audit plan are **inter-related** because change in one would result into change in the other.

CHAPTER - 3

Risk Assessment and Internal Control

Question 1

Briefly describe the various stages of a Risk Assessment process.

Answer

Risk Assessment is one of the most critical components of Enterprise Risk Management. The risk assessment process involves considerations for **qualitative and quantitative factors**, definition of key performance and risk indicators, risk appetite, risk scores, scales and maps, use of data & metrics and benchmarking. **The various stages in a Risk Assessment process are as follows:**

- Define **Business Objectives** and Goals;
- Identify **events** that affect achievement of business objectives;
- Assess **likelihood** and impact;
- Respond and **mitigate risks**;
- Assess **residual risk**.

Question 2

What are the components of an internal control framework?

Answer

There are **five components** of an internal control framework. They are as follows:

- **Control Environment;**
- **Risk Assessment;**
- **Information & Communication;**
- **Monitoring;**
- **Control Activities.**

Question 3

Explain briefly the Flow Chart technique for evaluation of the Internal Control system.

Answer

The flow charting technique can also be resorted to for **evaluation of the internal control system**. It is a **graphic presentation of internal controls** in the organisation and is normally drawn up to show the controls in each section or sub-section. As distinct from a narrative form, it provides the most **concise and comprehensive way for reviewing the internal controls** and the evaluator's findings. In a flow chart, narratives, though cannot perhaps be totally banished are reduced to the minimum and by that process, it can successfully bring the whole control structure, specially the essential parts thereof, in a condensed but wholly meaningful manner. It gives a **bird's eye view of the system** and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart. Essentially **a flow chart is a diagram full with lines and symbols** and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organisation.

A properly drawn up flow chart can provide a neat visual picture of the whole activities of the section or department involving flow of documents and activities.

More specifically it can show -

- (i) at what point a **document is raised** internally or received from external sources;
- (ii) the **number of copies** in which a document is raised or received;
- (iii) **distribution** of the documents to various sections, department or operations;
- (iv) checking **authorisation** and matching at relevant stages;
- (v) **filing** of the documents; and
- (vi) **final disposal** by sending out or destruction.

Drawing of a flow chart - A flow chart is **normally a horizontal one** in which documents and activities are shown to flow horizontally from section to section and the concerned sections are shown as the vertical column heads; in appropriate cases an individual also may be shown as the vertical column head. Care should be taken to see that the first column head is devoted to the section or the individual wherefrom a transaction originates and the placements of other column heads should be in the order of the actual flow of the transaction.

Question 4

Prabhu Ltd., a manufacturing concern wants to develop internal control system. You are an expert in developing the internal control system, hereby called to brief about the same. In view of above, you are required to brief about internal control system and inherent limitations of the internal control?

Answer

Internal Control System and its Inherent Limitations: As per Guidance Note on Audit of Internal Financial Control over Financial Reporting, internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met.

"Internal Control System" **means all the policies and procedures** (internal controls) **adopted by the management** of an entity to assist in achieving management's objective **of ensuring**, as far as practicable, the **orderly and efficient conduct of its business**, including adherence to management policies, the **safeguarding of assets**, the **prevention and detection of fraud and error**, the **accuracy and completeness of the accounting records**, and the **timely preparation** of reliable financial information.

To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

An internal control system:

- ◆ Facilitates the effectiveness and efficiency of operations.
- ◆ Helps ensure the reliability of internal and external financial reporting.
- ◆ Assists compliance with laws and regulations.
- ◆ Helps safeguarding the assets of the entity.

Limitations of Internal Control - Internal control, no matter how effective, **can provide** an entity with **only reasonable assurance and not absolute assurance** about achieving the entity's operational, financial reporting and compliance objectives. Internal control systems are subject to **certain inherent limitations**, such as:

- ◆ Management's consideration that the **cost of an internal control does not exceed the expected benefits** to be derived.
- ◆ The fact that most internal controls do not tend to be directed at transactions of **unusual nature**. The **potential for human error**, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- ◆ The possibility of **circumvention of internal controls** through collusion with employees or with parties outside the entity.
- ◆ The possibility that a **person responsible** for exercising an internal control **could abuse that responsibility**, for example, a member of management overriding an internal control.
- ◆ **Manipulations by management** with respect to transactions or estimates and judgements required in the preparation of financial statements.

Question 5

During the course of audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in the mind while drafting the letter of weaknesses in internal control system.

Answer

Important Points to be kept in Mind While Drafting Letter of Weakness: As per SA 265, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management", the auditor shall include in the written communication of significant deficiencies in internal control -

- (i) A **description of the deficiencies** and an explanation of their potential effects; and
- (ii) **Sufficient information** to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should **communicate material weaknesses** to the management or the audit committee, if any, **on a timely basis**. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows-

- (1) The letter lists down the **area of weaknesses** in the system and offers **suggestions** for improvement.
- (2) It should clearly indicate that it **discusses only weaknesses** which have **come to the attention of the auditor** as a result of his audit and that his examination has not been

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designed to determine the adequacy of internal control for management.

- (3) This letter serves as a **valuable reference document** for management for the purpose of revising the system and insisting on its strict implementation.
- (4) The letter may also serve to **minimize legal liability** in the event of a major defalcation or other loss resulting from a weakness in internal control.

Question 6

ST Ltd is a growing company and currently engaged in the business of manufacturing of tiles. The company is planning to expand and diversify its operations. The management has increased the focus on the internal controls to ensure better governance. The management had a discussion with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of the company's objectives. Please advise the management and the auditor on the steps that should be taken for the same.

Or

What are the General Steps in the conduct of Risk based audit?

Answer

The auditor's objective in a risk-based audit is to **obtain reasonable assurance that no material misstatements whether caused by fraud or errors exist** in the financial statements.

This involves the following **three key steps**:

- **Assessing the risks of material misstatement** in the financial statements
- Designing and performing further audit procedures that respond to assessed risks and **reduce the risks of material misstatements in the financial statements to an acceptably low level**; and
- **Issuing an appropriate audit report** based on the audit findings.

The risk-based audit process is presented in **three distinct phases**:

- **Risk assessment.**
- **Risk response; and**
- **Reporting.**

Question 7

BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2020-21. In order to review internal controls of the sales department of the company, you visited the department and noticed the work division as follows:

- (1) An officer was handling the sales ledger and cash receipts.
 - (2) Another official was handling dispatch of goods and issuance of Delivery challans.
 - (3) One more officer was there to handle customer/ debtor accounts and issue of receipts.
- (a) As an internal auditor you are required to briefly discuss the general condition pertaining to the internal check system.
- (b) Do you think that there was proper division of work? If not, why?

Answer

(a) **Internal Check System:** The general condition pertaining to the internal check system may be summarized as under:

- (i) **no single person should have complete control** over any important aspect of the

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business operation. Every employee's action should come under the review of another person.

- (ii) Staff duties should be **rotated from time to time** so that members do not perform the same function for a considerable length of time.
 - (iii) Every member of the staff should be encouraged to go on **leave at least once a year**.
 - (iv) Persons having **physical custody** of assets must **not be permitted to have access to the books of accounts**.
 - (v) There should **exist an accounting control** in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
 - (vi) **Mechanical devices** should be used, where ever practicable to prevent loss or misappropriation of cash.
 - (vii) **Budgetary control** should be exercised and wide deviations observed should be reconciled.
 - (viii) **For inventory taking**, at the close of the year, **trading activities** should, if possible be **suspended**, and it should be done by staff belonging to several sections of organization.
 - (ix) The **financial and administrative powers** should be **distributed very judiciously** among different officers and the manner in which those are actually exercised should be reviewed periodically.
 - (x) **Procedures** should be laid down **for periodical verification** and testing of different sections of accounting records to ensure that they are accurate.
- (b) **Division of Work:** Company has not done proper division of work as:
- (i) the **receipts of cash** should **not be handled by the official handling sales ledger**.
 - (ii) **delivery challans** should be **verified** by an authorised official other than the officer handling despatch of goods.

Question 8

Navjeevan Hospital is a multi-speciality hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the person in charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. According to you, which basis system of control has been violated? Also list down the other general conditions pertaining to such system which needs to be maintained and checked by the management.

Answer

Basic system of Control: Internal Checks and Internal Audit are important constituents of Accounting Controls. **Internal check system implies organization of the overall system of book-keeping** and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.

In the given case of Navjeevan Hospital, the person-in-charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. Thus, **one of the basic system of control i.e. internal check which includes segregation of duties or maker and checker has been violated** where transaction processing are allocated to different persons in such a manner that no one person can carry through completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person.

The general condition pertaining to the internal check system may be summarized as under-

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- (i) **No single person should have complete control** over any important aspect of the business operation. Every employee's action should come under the review of another person.
- (ii) Staff duties should be **rotated from time to time** so that members do not perform the same function for a considerable length of time.
- (iii) Every member of the staff should be encouraged to go on **leave at least once a year**.
- (iv) Persons having **physical custody** of assets must **not be permitted to have access to the books of accounts**.
- (v) There should **exist an accounting control** in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.
- (vi) **Mechanical devices** should be used, where ever practicable to prevent loss or misappropriation of cash.
- (vii) **Budgetary control** should be exercised and wide deviations observed should be reconciled.
- (viii) **For inventory taking**, at the close of the year, **trading activities** should, if possible be **suspended**, and it should be done by staff belonging to several sections of the organization.
- (ix) The **financial and administrative powers** should be **distributed very judiciously** among different officers and the manner in which those are actually exercised should be reviewed periodically.
- (x) **Procedures** should be laid down **for periodical verification** and testing of different sections of accounting records to ensure that they are accurate.

Question 9

In the use of standardized Internal Control Questionnaire (ICQ), certain basic assumptions about elements of a good internal control system are taken into account. List down few such assumptions.

Answer

Basic Assumption about Elements of Good Control in Standardized Internal Control Questionnaire: In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -

- (i) Certain procedures in general used by most business concerns are essential in **achieving reliable internal control**. This is a **time-tested assumption**. Deposit into bank of the entire receipts of a day or daily balancing of the cash book and ledgers or periodic reconciliation with the control accounts are examples of widely used practices which are considered good internal control practices. Besides, basic operations giving rise to these practices exist in all businesses irrespective of their nature.
- (ii) Organisations are such that permit an **extensive division of duties and responsibilities**. The larger the organisation, the greater is the scope of such division.
- (iii) Employees concerned with **accounting function are not assigned any custodial function**.
- (iv) No single person is thrust with the responsibility of completing a transaction all by himself.
- (v) There should always be **evidence to identify the person who has done the work** whether involving authorisation, implementation or checking.
- (vi) The **work performed** by each one is expected to **come under review** of another in the usual course of routine.
- (vii) There is **proper documentation** and recording of the transactions.

Question 10

The Entity's Risk Assessment Process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of occurrence and decides upon actions to respond to and manage them and the results thereof. Elucidate the circumstances in which risks can arise or change.

Answer

Entity's Risk Assessment Process: Risks can arise or change due to circumstances such as the following-

- (i) **Changes in operating environment:** Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- (ii) **New personnel:** New personnel may have a different focus on or understanding of internal control.
- (iii) **New or revamped information systems:** Significant and rapid changes in information systems can change the risk relating to internal control.
- (iv) **Rapid growth:** Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- (v) **New technology:** Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- (vi) **New business models, products, or activities:** Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- (vii) **Corporate restructurings:** Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- (viii) **Expanded foreign operations:** The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- (ix) **New accounting pronouncements:** Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Question 11

As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?

Answer

Basic Accounting Control Objectives: The basic accounting control objectives which are sought to be achieved by any accounting control system are -

- (i) Whether all transactions are **recorded**;
- (ii) Whether recorded transactions are **real**;
- (iii) Whether all recorded transactions are **properly valued**;
- (iv) Whether all transactions are recorded **timely**;
- (v) Whether all transactions are properly **posted**;

(vi) Whether all transactions are properly **classified and disclosed**;

(vii) Whether all transactions are properly **summarized**.

Question 12

Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money.

Answer

Control System over Selling and Collection of Tickets: In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

- (i) **Printing of tickets:** Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.
- (ii) **Ticket sales:** The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.
- (iii) **Daily cash reconciliation:** Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.
- (iv) **Daily banking:** Each day's collection should be deposited in the bank on next working day of the bank. Till that time, the cash should be in the custody of properly authorized person preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.
- (v) **Entrance ticket:** Entrance tickets should be cancelled at the entrance gate when public enters the centre.
- (vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.
- (vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.
- (viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Question 13

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Explain.

Answer

Communication and enforcement of integrity and ethical values: The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the **product of the entity's ethical and**

behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, **management actions to eliminate or mitigate incentives or temptations** that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the **communication of behavioral standards to personnel through policy statements and codes of conduct** and by example.

Question 14

Your engagement team is seeking advice from you as engagement partner regarding steps for risk identification. Elaborate.

Answer

Steps for Risk Identification:

- Assess the **significance of the assessed risk**, impact of its occurrence and also revise the materiality accordingly for the specific account balance.
- Determine the **likelihood for assessed risk** to occur and its impact on our auditing procedures.
- **Document the assertions** that are effected.
- Consider the **impact of the risk** on each of the assertions
- **(completeness, existence, accuracy, validity, valuation and presentation)** relevant to the account balance, class of transactions, or disclosure.
- Identify the **degree of Significant risks** that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- Enquire and document the **management's response**.
- Consider the **nature of the internal control system in place** and its possible effectiveness in mitigating the risks involved. Ensure the controls :
 - ❖ Routine in nature (occur daily) or periodic such as monthly.
 - ❖ Designed to prevent or detect and correct errors.
 - ❖ Manual or automated.
- Consider **any unique characteristics** of the risk.
- Consider the **existence of any particular characteristics (inherent risks)** in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures.
- Examples could include **high value inventory, complex contractual agreements**, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

Question 15

State the considerations on which effectiveness of an efficient system of internal check depends.

Answer

Considerations for the effectiveness of a System of Internal Check: The effectiveness of an efficient system of internal checks depends on the following considerations:

- (i) **Clarity of responsibility** – The responsibility of different persons engaged in various operations of business transactions should be properly identified. A well-integrated organizational chart depicting the names of responsible persons associated with specific functions may help to fix up responsibility.
- (ii) **Division of work** – The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other. Then, it is suggested that rotation of different employees through various components of job should be effectively implemented.
- (iii) **Standardization** – The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of business, so as to strengthen the system of internal checks.
- (iv) **Appraisal** – Periodic review should be made of the chain of operations and flow. Such process may be carried out by preparing an audit flow chart.

Question 16

Explain the concept of Integrated framework issued by Committee of the Sponsoring Organisations of the Treadway Commission (COSO Framework) duly mentioning its four out of five components and discuss the three category of objectives that can be achieved as per COSO framework.

Answer

COSO's Internal Control – Integrated Framework was introduced in 1992 as **guidance on how to establish better controls** so companies can achieve their objectives. COSO categorizes entity – level objectives into **operations, financial reporting, and compliance**. The framework includes more than 20 basic principles representing the fundamental concepts **associated with its five components: control environment, risk assessment, control activities, information and communication, and monitoring**. Some of the principles include key elements for compliance, such as integrity and ethical values, authorities and responsibilities, policies and procedures, and reporting deficiencies.

The COSO Framework is designed to be used by organizations to **assess the effectiveness of the system of internal control** to achieve objectives as determined by management. **The Framework lists three categories of objectives as below:**

- **Operations Objectives** – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
- **Reporting Objectives** – related to internal and external financial and non-financial reporting to stakeholders, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
- **Compliance objectives** – In the Framework, the compliance objective was described as "relating to the entity's compliance with applicable laws and regulations." The Framework considers the increased demands and complexities in laws, regulations, and accounting standards.

Chapter 4

Auditing in an Automated Environment

Question 1

Describe application controls and give three examples of automated application controls.

Answer

Application Controls are automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems. **Examples of automated applications include:**

- **Edit checks** and validation of input data;
- **Sequence number** checks;
- **User limit** checks;
- **Reasonableness** checks;
- Mandatory **data fields**.

Question 2

In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. You are required to briefly explain the relevant considerations of every phase in above audit approach in case of automated environment.

Answer

In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. In this approach, the considerations of automated environment will be relevant at every phase as given below:

- during risk assessment, the auditor should consider **risk arising from the use of IT systems** at the company;
- when obtaining an understanding of the business process and **performing walkthroughs** the use of IT systems and applications should be considered;
- while assessing the entity level controls the aspects related to **IT governance** need to be understood and reviewed;
- pervasive controls including **segregation of duties**, general IT controls and applications should be considered and reviewed;
- during **testing phase**, the results of general IT controls would impact the nature, timing and extent of testing;
- when testing of reports and information produced by the entity (IPE) generated through **IT systems and applications**;
- at **completion stage**, evaluation of control deficiencies may require using data analytics and CAATs.

Alternative Answer

In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. In this approach, the considerations of automated environment will be relevant at every phase as given below:

Special Aspects of Auditing in an Automated Environment

I. Risk Assessment Process

- Identify significant accounts and disclosures.
- Qualitative and Quantitative considerations.
- Relevant Financial Statement Assertions (FSA).
- Identify likely sources of misstatement.
- Consider risk arising from use of IT systems.

II. Understand and Evaluate

- Document understanding of business processes using Flowcharts / Narratives.
- Prepare Risk and Control Matrices (RCM).
- Understand design of controls by performing walkthrough of end-to-end process.
- Process wide considerations for Entity Level Controls, Segregation of Duties.
- IT General Controls, Application Controls.

III. Test for Operating Effectiveness

- Assess Nature, Timing and Extent (NTE) of controls testing.
- Assess reliability of source data; completeness of population.
- Testing of key reports and spreadsheets.
- Sample testing.
- Consider competence and independence of staff /team performing controls testing.

IV. Reporting

- Evaluate Control Deficiencies.
- Significant deficiencies, Material weaknesses.
- Remediation of control weaknesses.
- Internal Controls Memo (ICM) or Management Letter.
- Auditor's report.

Question 3

A real-time environment is a type of automated environment in which business operations and transactions are initiated, processed and recorded immediately as they happen without delay. It has several critical IT components that enable anytime, anywhere transactions to take place. You are required to name the components and its example of real-time environment.

Answer

Real Time Environment: IT Components: To facilitate transactions in real-time, it is essential to have the systems, networks and applications available during all times. A real-time environment has several critical IT components that enable anytime, anywhere transactions to take place. Any failure even in one component could render the real-time system unavailable and could result in a loss of revenue. IT Components include:

- Applications:** For example, ERP applications SAP, Oracle R12, Core banking applications.
- Middleware:** For example, Webservers like Apache, ATM switches.
- Networks:** For example, Wide Area Networks, Internet hosting.
- Hardware:** For example, Data centers, Backup and Storage devices, Power supply.

Question 4

In an automated environment, the data stored and processed in systems can be used to get various insights into the way business operates. This data can be useful for preparation of management information system (MIS) reports and electronic dashboards that give a high-level snapshot of business performance. In view of above you are required to briefly discuss the meaning of data analytics and example of circumstances when auditing in an automated environment, auditors can apply the concepts of data analytics.

Answer

Data Analytics: Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics. The data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs. When auditing in an automated environment, auditors can apply the concepts of data analytics for several aspects of an audit including the following:

- **preliminary analytics;**
- **risk assessment;**
- **control testing;**
- **non-standard journal analysis;**
- **evaluation of deficiencies;**
- **fraud risk assessment.**

Question 5

“Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics and the data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs.” You are required to give a suggested approach to get the benefit from the use of CAATs.

Answer

There are several steps that should be followed to achieve success with CAATs and any of the supporting tools. A suggested approach to benefit from the use of CAATs is given below:

- Understand **Business Environment** including IT;
- Define the **Objectives** and Criteria;
- Identify **Source and Format** of Data;
- **Extract** Data;
- Verify the **Completeness and Accuracy** of Extracted Data;
- Apply **Criteria** on Data Obtained;
- Validate and **Confirm Results.**

Question 6

While evaluating the risks and controls at entity level, the Auditor should take cognizance of the prevalent direct and indirect entity level controls operating in the entity. Explain what they pertain to, with few examples.

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Answer

Entity Level Risks and Controls: There are direct entity level controls and indirect entity level controls.

- (i) **Direct ELCs** operate at a level higher than business activity or transaction level such as a business process or sub-process level, account balance level, at a sufficient level of precision, to **prevent, detect or correct a misstatement in a timely manner.**

Examples include:

- Business **performance reviews;**
- Monitoring of **effectiveness of controls** activities by Internal Audit function;

- (ii) **Indirect ELCs** do not relate to any specific business process, transaction or account balance and hence, **cannot prevent or detect misstatements.** However, they contribute indirectly to the effective operation of direct ELC and other control activities.

Examples include:

- Company **code of conduct** and ethics policies;
- **Human resource policies;**
- Employee **job roles** & responsibilities.

Question 7

A newly qualified professional has received his first appointment as auditor of a large company and is very much concerned about the effectiveness of internal control and wants to assess and evaluate the control environment as part of his audit program. Towards achieving his objective, he seeks your help in knowing the Standard Operating Procedures (SOPs) of assessment and evaluation of control.

Answer

Standard Operating Procedures (SOPs): A well-defined set of SOPs helps define role, responsibilities, process & controls & thus helps clearly communicate the operating controls to all touch points of a process. The controls are likely to be clearly understood & consistently applied even during employee turnover.

- (i) **Enterprise Risk Management:** An organization which has robust process to identify & mitigate risks across the enterprise & its periodical review will assist in early identification of gaps & taking effective control measures. In such organizations, surprises of failures in controls is likely to be few.
- (ii) **Segregation of Job Responsibilities:** A key element of control is that multiple activities in a transaction/decision should not be concentrated with one individual. Segregation of duties is an important element of control such that no two commercial activities should be conducted by the same person.
- (iii) **Job Rotation in Sensitive Areas:** Any job carried out by the same person over a long period of time is likely to lead to complacency & possible misuse in sensitive areas. It is therefore important that in key commercial functions, the job rotation is regularly followed to avoid degeneration of controls. For example, if the same buyer continues to conduct purchase function for long period, it is likely that he gets into comfort zone with existing vendors & hence does not exercise adequate controls in terms of vendor development, competitive quotes etc.
- (iv) **Delegation of Financial Powers Document:** As the organization grows, it needs to delegate

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the financial & other powers to their employees. A clearly defined document on delegation of powers allows controls to be clearly operated without being dependent on individuals.

- (v) **Information Technology based Controls:** With the advent of computers & enterprise resource planning (ERP) systems, it is much easier to embed controls through the system instead of being human dependent. The failure rate for IT embedded controls is likely to be low, is likely to have better audit trail & is thus easier to monitor. For example, at the stage of customer invoicing, application of correct rates in invoices or credit control can all be exercised directly through IT system improving control environment.

Question 8

The volatility, unpredictability and pace of fast changes that exists in the automated environment today is far greater than in the past and consequently it throws more risk to business which requires them to have a need to continuously manage such risks. State various risks which an enterprise may have to face and manage.

Answer

Various Risk: Businesses today operate in a dynamic environment. The volatility, unpredictability and pace of changes that exist in the business environment today is far greater than in the past. Some of the reasons for this dynamic environment include globalization, use of technology, new regulatory requirements, etc. Because of this dynamic environment the associated risks to business have also increased and companies have a need to **continuously manage risks**.

Examples of risks include:

- **Market Risks;**
- **Regulatory & Compliance Risks;**
- **Technology & Security Risks;**
- **Financial Reporting Risks;**
- **Operational Risks;**
- **Credit Risk;**
- **Business Partner Risk;**
- **Product or Project Risk;**
- **Environmental Risks.**

Question 9

"The audit cycle consists of Planning, Execution and Completion. The automation in processing of business transactions has considerations to be weighed by Auditor at every phase of this cycle." Enumerate the focal points of such considerations when auditing in automated environment.

Answer

Consideration of Automated Environment at Each Phase of Audit Cycle: In a controls- based audit, the audit approach can be classified into **three broad phases comprising of planning, execution, and completion**. In this approach, the considerations of automated environment will be relevant at every phase as given below:

- during risk assessment, the auditor should consider **risk arising from the use of IT systems** at the company;
- when obtaining an understanding of the business process and **performing walkthroughs** the use of IT systems and applications should be considered;
- while assessing the entity level controls the **aspects related to IT governance** need to be understood and reviewed;

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- **pervasive controls including segregation of duties**, general IT controls and applications should be considered and reviewed;
- during testing phase, the results of general IT controls would impact the **nature, timing and extent of testing**;
- when **testing of reports** and information produced by the entity (**IPE**) generated through IT systems and applications;
- at completion stage, **evaluation of control deficiencies** may require using data analytics and CAATs.

Question 10

Write short note on Understanding and documenting automated environment

Answer

Understanding and Documenting Automated Environment: Understanding of the automated environment of a company **is required as per SA 315**. The auditor's understanding of the automated environment should include the following:

- The **applications** that are being used by the company;
- Details of the **IT infrastructure** components for each of the application;
- The **organisation structure** and governance;
- The **policies**, procedures and processes followed;
- **IT risks and controls**.

The auditor is required to **document** the understanding of a company's automated environment **as per SA 230**.

Question 11

In a risk-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. You are required to briefly explain the relevant considerations for every phase in above audit approach in case of an automated environment.

Answer

In a controls-based audit in an automated environment, the audit approach can be **classified into three broad phases comprising of planning, execution, and completion**. In this approach, the considerations of automated environment will be relevant at every phase as given below:

- during risk assessment, the auditor should **consider risk arising from the use of IT systems** at the company;
- when obtaining an understanding of the business process and performing walkthroughs the **use of IT systems and applications** should be considered;
- while assessing the entity level controls the **aspects related to IT governance** need to be understood and reviewed;
- **pervasive controls** including segregation of duties, general IT controls and applications should be considered and reviewed;
- during testing phase, the **results of general IT controls** would impact the nature, timing

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and extent of testing;

- when testing of reports and information produced by the entity (IPE) generated through IT systems and applications;
- at completion stage, **evaluation of control deficiencies** may require using data analytics and CAATs.

Question 12

A Company is using ERP for all its business processes including Procurement, Sales, Finance and Reporting. You are required to explain the Statutory Auditor's approach to identify the risks associated with the IT systems.

Answer

The Auditor should understand and **document each of the business processes** in form of narratives and / or flowcharts. The next process will be to **identify areas / events that can lead to risks**, viz. manual Invoicing and accounting once goods are dispatched could lead to incorrect Invoicing and accounting and hence is a 'risk'. The Auditor should also **analyse the risks** i.e. the impact it will have **if materializes**. Next will be prioritization in terms of probability of how often the risks will materialize.

Question 13

Explain some of the International IT related Standards, Guidelines and Framework.

Answer

When auditing in an automated environment the auditor should be aware, adhere to and be guided by the various standards, guidelines and procedures that may be relevant to both audit and the automated environment. **Given below are some of the common standards and guidelines that are relevant in this context include:**

Standards on Auditing issued by the Institute of Chartered Accountants of India, are required to be followed for an audit of financial statements.

Section 143 of Companies Act 2013 requires statutory auditors to provide an Independent Opinion on the Design and Operating Effectiveness of Internal Financial Controls Over Financial Reporting (IFC-FR) of the company as at Balance Sheet date. For this purpose, the **Guidance Note on Audit of Internal Financial Controls Over Financial Reporting** issued by the Institute of Chartered Accountants of India, provides the framework, guidelines and procedures for an audit of financial statements.

Sarbanes Oxley Act of 2002, commonly known as SOX, is a requirement in America. Section 404 of this act requires public listed companies to implement, assess and ensure effectiveness of internal controls over financial reporting and auditors independent opinion on the design and operating effectiveness of internal controls over financial reporting (ICFR) – which is similar to the requirements of IFC-FR for Indian companies. Similar legal and statutory requirements over internal controls exist in several other countries including Japan, China, European Countries, etc.

ISO 27001:2013 is the Information Security Management System (ISMS) standard issued by the International Organization for Standardization (ISO). This standard provides the framework,

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guidelines and procedures for implementing information security and related controls in a company. For example, this standard covers password security, application security, physical security, backup and recovery, that are relevant when auditing in an automated environment.

ITIL (Information Technology Infrastructure Library) and ISO 20000 provide a set of best practice processes and procedures for IT service management in a company. For example, change management, incident management, problem management, IT operations, IT asset management are some of the areas that could be relevant to audit.

The Payment Card Industry – Data Security Standard or PCI-DSS, is the most widely adopted information security standard for the payment cards industry. Any company that is involved in the storage, retrieval, transmission or handling of credit card/debit card information are required to implement the security controls in accordance with this standard.

The American Institute of Certified Public Accountants has published a **framework under the Statements on Standards for Attest Engagements (SSAE) No.16** for reporting on controls at a service organisation that include

- ❖ **SOC 1 for reporting** on controls at a service organization relevant to user entities' internal control over financial reporting (ICFR).
- ❖ **SOC 2 and SOC 3** for reporting on controls at a service organization relevant to security, availability, processing integrity, confidentiality or privacy i.e., controls other than ICFR.
- ❖ While SOC 1 and SOC 2 are restricted use reports, SOC 3 is general use report.

Control Objectives for Information and Related Technologies (CoBIT) is best practice IT Governance and Management framework published by Information Systems Audit and Control Association. CoBIT provides the required tools, resources and guidelines that are relevant to IT governance, risk, compliance and information security.

The Cybersecurity Framework (CSF) published by the National Institute of Standards and Technology is one of the most popular framework for improving critical infrastructure cybersecurity. This framework provides a set of standards and best practices for companies to manage cybersecurity risks.

Question 14

Explain Application Controls and General IT Controls.

Answer

Application Controls: Application controls **include both automated and manual controls** that operate at a business process level. Application controls **can be preventive as well as detective in nature** and are designed to ensure the integrity of the accounting records. application controls relate to procedures used to initiate, record, process and report transactions or other financial data. The se controls help **ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed**. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems. **Examples of automated applications include edit checks and validation of input data, sequence number check, limit check, format check, range check, reasonableness check, mandatory data fields, existence check etc.**

General IT Controls: “General IT controls are policies and procedures that **relate to many applications and support the effective functioning of application controls**. They apply to mainframe, miniframe, and end-user environment. General IT controls that maintain the **integrity**

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of information and **security of data** commonly include controls over the following:" (SA 315)

- **Data center and network operations;**
- **System software acquisition, change and maintenance**
- **Program change;**
- **Access security;**
- **Application system acquisition, development, and maintenance (Business Applications).**

These are IT controls generally implemented to **mitigate the IT specific risks** and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

Question 15

CA Vipin has been appointed as Statutory Auditor by IG Insurance Co. Ltd. for 3 of its branches for the F.Y. 2020-21. Insurance Company is using a software called "Applied Epic" wherein all transactions (policy issuance, premium receipts, expense of insurance company, incomes, assets and liabilities) are recorded and financial statements generated at the end of the financial year. CA Vipin not technically equipped and well versed with technology, decided to follow traditional manual auditing approach and started the audit. He is of the view that understanding and using the auditee's automated environment is optional and not required. Do you agree with the approach and views of CA Vipin.?

Answer

Understanding of the automated environment of a company **is required as per SA 315**. The auditor's understanding of the automated environment **should include the following:**

- The **applications** that are being used by the company;
- Details of the **IT infrastructure** components for each of the application;
- The **organisation structure** and governance;
- The **policies**, procedures and processes followed;
- **IT risks and controls.**

The auditor is required to **document** the understanding of a company's automated environment **as per SA 230**.

CHAPTER - 5

Company Audit

Question 1

Mr. Ajay, a Chartered Accountant has been appointed as an auditor of Bharat Ltd. in the Annual General Meeting of the company held in September, 2019, which assignment he accepted. Subsequently in February, 2020, he joined Mr. Bajaj, another Chartered Accountant, who is the Manager Finance of Bharat Ltd., as partner.

Answer

Provisions and Explanation: Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. Ajay, an auditor of Bharat Ltd., joined as partner with Mr. Bajaj, who is Manager Finance of Bharat Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Bharat Limited.

Question 2

CA. P is providing the services of Design and implementation of financial information system to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

Answer

Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which includes Design and implementation of financial information system.

Therefore, CA. P is advised not to accept the assignment of auditing as the service he is rendering is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

Question 3

“Mr. Avi”, a practicing Chartered Accountant, is holding securities of “XYZ Ltd.” having face value of ₹ 990/-. Whether Mr. Avi is qualified for appointment as an Auditor of “XYZ Ltd.”?

Answer

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

In the present case, Mr. Avi. is holding security of ₹ 900 in XYZ Ltd, therefore, he is not eligible for appointment as an auditor of “XYZ Ltd”.

Question 4

“Mr. PK” is a practicing Chartered Accountant and “Mr. Qurashi”, the relative of “Mr. PK”, is holding securities of “ABC Ltd.” having face value of ₹ 99,000/-. Whether “Mr. PK” is Qualified for being appointed as an auditor of “ABC Ltd.”?

Answer

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further, as per proviso to this Section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the present case, Mr. Qurashi (relative of Mr. PK), is having securities of ₹ 99,000 face Value in ABC Ltd., which is as per requirements of proviso to section 141(3)(d)(i). Therefore, Mr. PK will not be disqualified to be appointed as an auditor of ABC Ltd.

Question 5

“M/s Bhavin & Co.” is an Audit Firm having partners “Mr. Bala” and “Mr. Chandu”. “Mr. A” the relative of “Mr. Chandu”, is holding securities of “AMD Ltd.” having face value of ₹ 1,00,100/-. Whether “M/s Bhavin & Co.” is qualified for being appointed as an auditor of “AMD Ltd.”?

Answer

As per section 141(3)(d)(i), a person is disqualified to be appointed as an auditor if he, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company: Further as per proviso to this Section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s Bhavin & Co, will be disqualified for appointment as an auditor of AMD Ltd as the relative of Mr. Chandu (i.e. partner of M/s Bhavin & Co.), is holding the securities in AMD Ltd which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Question 6

M/s Rajamohan & Co. is an audit firm having partners CA. Raja and CA. Mohan. The firm has been offered the appointment as an auditor of Inn Ltd. for the Financial Year 2019-20. Mr. Bee, the relative of CA. Raja, is holding 8,000 shares (face value of ₹ 10 each) in Inn Ltd. having market value of ₹ 1,60,000. Whether M/s Rajamohan & Co. is disqualified to be appointed as auditors of Inn Ltd.?

Answer

As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s Rajamohan & Co. is an audit firm having partners CA. Raja and CA. Mohan. Mr. Bee is a relative of CA. Raja and he is holding shares of Inn Ltd. of face value of ₹ 80,000 only (8,000 shares x ₹ 10 per share).

Therefore, M/s Rajamohan & Co. is not disqualified for appointment as an auditors of Inn Ltd. as the relative of CA. Raja (i.e. partner of M/s Rajamohan & Co.) is holding the securities in Inn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of Companies Act, 2013.

Question 7

PQ & Co. is an audit firm with P and Q as partners. For the financial year 2019-20, the firm has been appointed as statutory auditor of M/s Mango Orchards Hotel Ltd. The audit firm is a regular customer of the hotel and the partners usually stay in the same hotel at various locations in the course of travelling for their various professional assignments. Normally, payments for such stay are settled against quarterly bills raised by the company. Give your comment with respect to the Companies Act, 2013.

Answer

Indebtedness to the Company: According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding ₹ 5,00,000 shall be disqualified to act as an auditor of such company and further under section 141(4) he shall vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

Further a person or a firm who directly or indirectly has business relationship with a company or its subsidiary or its holding or associate company, is also not qualified to be appointed as auditor of the company. But here business relationship does not include commercial transactions which are in the ordinary course of the business of the company at arm's length price.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, PQ & Co., an audit firm with P & Q as partners is appointed as statutory auditor of M/s Mango Orchards Hotel Ltd. and the audit firm is a regular customer of the hotel and the partners usually stay in the same hotel at various locations. They also settle the payments for such stay against quarterly bills raised by the company.

Assuming the balance amount at any time during the year due to the hotel does not exceed the prescribed limits of rupees 5,00,000, PQ & Co., is not disqualified to be appointed as statutory auditor of M/s Mango Orchards Hotel Ltd as per section 141(3)(d)(ii), in the absence of the same the auditor shall be disqualified to act as an auditor and shall vacate his office of auditor when he incurs this disqualification subsequent to the appointment.

Since in term of section 141(3)(e) of Companies Act, 2013 PQ & Co. is not a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed, the auditor shall not be disqualified to act as an auditor and shall not required to vacate his office of auditor.

Question 8

R and M is an audit firm having partners CA. R, CA. M and CA. G. Mr. S is the relative of CA. R holding shares of STP Ltd. having a face value of ₹ 1,51,000. Whether CA. R and CA. M are qualified to be appointed as auditors of STP Ltd.?

Answer

Holding of Shares by Relative of Partner: As per section 141(3)(d)(i) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further as per proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, R and M is an audit firm having partners CA. R, CA. M and CA. G. Mr. S is a relative of CA. R and he is holding shares of STP Ltd. of face value of ₹ 1,51,000.

Therefore, R and M, audit firm along with its partners CA. R, CA. M and CA. G will be disqualified for appointment as an auditor as the relative of CA. R is holding the securities in STP Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Thus, CA. R and CA. M will be disqualified to be appointed as auditors of STP Ltd.

Question 9

Navy and Cavy Associates, a Chartered Accountant firm, has been appointed as Statutory Auditor of Poor Ltd. for the financial year 2019-20. Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, is indebted for ₹ 6,00,000 to Wealthy Ltd., a subsidiary company of Poor Ltd. Comment.

Answer

Indebtness to the Subsidiary Company: As per sub-section (3)(d)(ii) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5 lakhs.

Also, as per sub-section (4) of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, has been indebted to Wealthy Ltd., a subsidiary company of Poor Ltd., for ₹ 6 lakhs.

Therefore, the firm, Navy and Cavy Associates would be disqualified to be appointed as statutory auditor of Poor Ltd. as per section 141(3)(d)(ii), which is the holding company of Wealthy Ltd., because Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, has been indebted to Wealthy Ltd. for an amount exceeding the minimum approved limit.

Question 10

Mr. Pratiq, a practicing Chartered Accountant, has been appointed as an auditor of Opus Ltd. He is holding securities of the company having face value of ₹ 89,000 only.

(i) You are required to state, whether Mr. Pratiq is qualified to be appointed as an auditor of

Opus Ltd.

- (ii) Would your answer be different, if instead of Mr. Pratiq; Mr. Quresh, the step-father of Mr. Pratiq, is holding the securities?

Answer

Disqualification due to Holding of Securities: According to section 141(3)(d)(i) of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

However, as per the proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

Further, the term “relative” has been defined under the Companies Act, 2013 which means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step- sister).

In the present situation,

- (i) Mr. Pratiq is holding securities in Opus Ltd., which is not allowed as per the provisions of section 141(3)(d)(i) of the Act. Therefore, Mr. Pratiq will be disqualified to be appointed as an auditor of Opus Ltd.

- (ii) Mr. Quresh, the step-father of Mr. Pratiq, is holding the securities in Opus Ltd.

It may be noted that step-father is included in the definition of the term “relative” as per the Companies Act, 2013. Further, proviso to section 141(3)(d)(i) of the Act allows a relative of the auditor to hold securities in the company of face value not exceeding of ₹ 1,00,000.

Here, Mr. Quresh is holding securities for face value of ₹ 89,000 which is below the limit as prescribed under the said proviso.

Therefore, Mr. Pratiq will not be disqualified to be appointed as an auditor of Opus Ltd.

Question 11

CA Adroit was indebted to Anfractuous (P) Ltd. for a sum of ₹ 6,00,000 as on 01.04.2019. However, CA Adroit having come to know that he might be appointed as auditor of the company, he squared up the amount on 10.7.2019. Later on, he was appointed as an auditor of the company for the year ended 31.3.2020 at the Annual General Meeting held on 16.07.2019.

Subsequently, one of the shareholders complains that the appointment of CA Adroit as an auditor is invalid because he incurred disqualification under section 141 of Companies Act, 2013. Comment.

Answer

Indebtness to the Company: According to the section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding ₹ 5,00,000 shall be disqualified to act as an auditor of such company and further under section 141(4) he shall vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, CA Adroit was indebted to Anfractuious (P) Ltd. for a sum of 6,00,000 as on 01.04.2019. He was appointed as an auditor of the company for the year ended 31.03.2020 at the Annual General Meeting held on 16.07.2019. He also repaid the loan amount fully to the company on 10.7.2019 i.e. before the date of his appointment.

Hence, the appointment of CA Adroit as an auditor is valid and the shareholder's complaint is not acceptable.

Question 12

Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2019-20. Mr. Hanuman, a partner of the Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd. Comment.

Answer

Auditor Holding Securities of a Company: As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

Also, as per sub-section (4) of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. Therefore, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd. as per section 141(3)(d)(i), which is the holding company of Shiva Ltd., because Mr. Hanuman one of the partner is holding equity shares of its subsidiary.

Question 13

Mr. Y, a practising Chartered Accountant, has been appointed as an auditor of M/s Z Ltd on 12th June, 2019 for the year ended 31st March, 2020. The following persons have done following transactions in securities of M/s Z Ltd.:

- Daughter of Mr. Y: Purchase of Securities on 10th September, 2019 of face value of ₹ 45,000 (market value ₹ 90,000)
- Husband of daughter of Mr. Y: Purchase of Securities on 10th December, 2019 of face value of ₹ 90,000 (market value ₹ 1,90,000).

All the above securities were sold on 10th March, 2020 for ₹ 3,00,000. Discuss the implications of the above on the appointment of Mr. Y.

Answer

Implications of relatives' securities holding on the Appointment of the Auditor: According to Section 141(3)(d)(i) of the Companies Act, 2013, read with Rule 10, an auditor is disqualified to be appointed as an auditor if the auditor or his relative holds securities or interest in the company of face value exceeding ₹100,000.

Further the definition of relative also includes daughter and a daughter's husband. Both are covered in the definition of relative as defined by the Companies Act 2013.

Thus, the disqualifications will be applicable as the relative/s are holding securities of face value of more than ₹ 100,000 and market value is not important.

It is also to note that in the event of acquiring any security or interest by a relative above the threshold prescribed, the corrective action to maintain the limits as specified above can be taken by the auditor within 60 days of such acquisition or interest. The same has however not been done.

In the instant case, Daughter of Mr. Y purchased the securities on 10th September 2019 of face value of rupees 45,000 and husband of daughter of Mr. Y purchased the securities on 10th of December, 2019 of face value of rupees 90,000. Aggregating the value of holding of securities exceeds the limits mentioned in proviso to section 141(3)(d)(i) i.e. rupees 1,00,000.

Further, corrective action taken by Husband of Daughter of Mr. Y on 10th March, is also not in accordance with prescribed grace period of 60 days.

Therefore, CA. Y will be disqualified for appointment as an auditor of M/s. Z Ltd. as per section 141(3)(d)(i) and he shall vacate his office.

Question 14

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

Answer

Appointment of the Auditor: Section 141 of the Companies Act 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

Further, as per Council Guidelines, 2008 a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are his relatives within the meaning of AS-18, have either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Ram is the relative of a Director of the company, therefore, he should not accept the appointment as an auditor of that company. If he accepts such appointment, he would be guilty of professional misconduct and would also be liable for punishment for contravention of the provisions of the Companies Act.

Question 15

As an auditor, how would you deal with the following situations:

- (a) Nick Ltd. is a subsidiary of Ajanta Ltd., whose 20% shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nick Ltd. appointed Mr. Prem as statutory auditor for the year.
- (b) Mr. Amar, a Chartered Accountant, bought a car financed at ₹ 7,00,000 by Chaudhary Finance

Ltd., which is a holding company of Charan Ltd. and Das Ltd. He has been the statutory auditor of Das Ltd. and continues to be even after taking the loan.

Answer

- (a)** According to Section 139(7) of the Companies Act, 2013, the auditors of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. As per section 2(45), a Government company is defined as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company as thus defined”.

In the given case Ajanta Ltd is a government company as its 20% shares have been held by Central Government, 25% by U.P. State Government and 10% by M.P. State Government. Total 55% shares have been held by Central and State governments. Therefore, it is a Government company.

Nick Ltd. is a subsidiary company of Ajanta Ltd. Hence Nick Ltd. is covered in the definition of a government company. Therefore, the Auditor of Nick Ltd. can be appointed only by C & AG.

Consequently, appointment of Mr. Prem is invalid and he should not give acceptance to the Directors of Nick Ltd.

- (b)** According to section 141(3)(d)(ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of any company, If he is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh.

In the given case Mr. Amar is disqualified to act as an auditor under section 141(3)(d)(ii) as he is indebted to M/s Chaudhary Finance Ltd. for more than ₹ 5,00,000. Also, according to section 141(3)(d)(ii) he cannot act as an auditor of any subsidiary of Chaudhary Finance Ltd. i.e. he is also disqualified to work in Charan Ltd. & Das Ltd. Therefore he has to vacate his office in Das Ltd. Even though it is a subsidiary of Chaudhary Finance Ltd.

Hence audit work performed by Mr. Amar as an auditor is invalid, he should vacate his office immediately and Das Ltd should appoint another auditor for the company.

Question 16

Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.

Answer

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company”. In the instant case, the proposed appointment of Shri Ganpati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 139(6) of the Companies Act, 2013, which requires the Board of Directors to appoint the first auditor of the company.

Conclusion: In view of the above, the Managing Director of PQR Ltd cannot appoint the first

auditor of the company.

Question 17

The first auditor of Healthy Wealthy Ltd., a Government company, was appointed by the Board of Directors.

Answer

Provisions and Explanation: Section 139(6) of the Companies Act, 2013 (the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company”. Thus, the first auditor of a company can be appointed by the Board of Directors within 30 days from the date of registration of the company. However, in the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence, in the case of Healthy Wealthy Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditors made by the Board of Directors of Healthy Wealthy Ltd. is null and void.

Question 18

IO Ltd. is registered with Registrar of Companies on 1st of May 2019. The Company's 27% of paid up share capital is held by Central Government; 28% by State Government and the remaining 45% by public. The Board of Directors appointed RMG, Chartered Accountants as statutory auditors for the financial year 2019-20 by passing a resolution at the Board Meeting held on 25th May, 2019. Comment whether appointment is valid or not.

Answer

Appointment of First Auditor of a Government Company: According to section 139(7) of the Companies Act, 2013, the first auditor of a government company shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. As per section 2(45) of the said Act, a Government Company is defined as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary company of such a Government Company.

In the given case, IO Ltd. is a government company as its 27% of paid-up share capital has been held by Central Government, 28% by State Government and remaining 45% by Public i.e. total 55% of the paid-up share capital has been held by Central Government and State Government which is more than 51% as prescribed in the Companies Act, 2013.

Therefore, the appointment of RMG, Chartered Accountants as first auditor by the Board of Directors of IO Ltd. for the financial year 2019-20 is not valid as the first auditor of a government company can be appointed by Comptroller and Auditor-General of India. If the CAG fails to make

such appointment within 60 days, the Board of Directors shall appoint within next 30 days.

Question 19

While auditing Y Ltd., CA Max, the statutory auditor of Y Ltd. encounters exceptional circumstances that bring into question his ability to continue performing the audit. Considering it appropriate, CA Max resigned from the office of auditor of Y Ltd. Due to the resignation of the existing auditor, the Board of Directors of Y Ltd. itself appointed CA Mini, a practicing Chartered Accountant, as the statutory auditor till the conclusion of 6th meeting.

You are required to state the provisions related to filling of casual vacancy as per the Companies Act, 2013 and comment upon the validity of appointment made by the Board.

Answer

Filling of Casual Vacancy: According to section 139(8) of the Companies Act, 2013, any casual vacancy in the office of an auditor shall-

- (i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

- (ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within he said period the Board of Directors shall fill the vacancy within next 30 days.

In the given case, CA Max, the statutory auditor of Y Ltd. has resigned from the office of auditor. Therefore, such casual vacancy can be filled by the Board of Directors subject to approval by the company at a general meeting convened within 3 months of the recommendation of the Board.

Thus, the appointment of CA Mini made by the Board of Directors without the approval of the company at a general meeting is invalid.

Further, if appointment is approved by the company, CA Mini cannot hold the office of auditor till the conclusion of 6th meeting i.e. the appointment cannot be made for five years. The auditor can hold office only till the conclusion of the next AGM.

Question 20

Malta Pvt. Ltd., a newly incorporated company dated 01.07.2019 is engaged in the manufacturing business of Cotton Shirts. On 30.07.2019, the Managing Director of Malta Pvt. Ltd. himself appointed CA Rajnath, his daughter's husband, as the first auditor of the company.

You are required to –

- (i) state the provisions of the Companies Act, 2013 relating to appointment of first auditor.
(ii) comment on the action of the Managing Director.

Answer

(i) Appointment of First Auditor: Provisions of the Companies Act, 2013 relating to appointment of first auditor are stated below-

(1) Appointment of First Auditor in the case of a company, other than a Government Company- As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

(2) Appointment of First Auditor in the case of Government Company- Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

(ii) **Appointment of First Auditor by the Managing Director:** Apparently, there are two issues arising out of the situation given in the question, viz., first one relates to appointment of first auditor by the Managing Director; and second pertains to relation of such an auditor with the Managing Director. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditor, it may be noted that as per the provisions of section 139(6) of the Companies Act, 2013, the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

As per the facts given in the case, the appointment of CA Rajnath as first auditor by the Managing Director of Malta Pvt. Ltd. by himself is in violation of section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company.

Thus, the appointment of CA Rajnath is not valid. Under the circumstances, the second issue relating to relationship of auditor with Managing Director becomes redundant.

Question 21

Ram Ltd. is a private company. Its balance sheet shows paid up share capital of ₹ 5 crore and public borrowings of ₹ 100 crore. The company appointed M/s Shyam & Co., a chartered accountant firm, as the statutory auditor in its annual general meeting held at the end of

September, 2019 for 11 years.

You are required to state the provisions related to - rotation of auditors and cooling off period as per the section 139(2) of the Companies Act, 2013 in case of an individual auditor or an audit firm, both, and comment upon the facts of the case provided above with respect to aforesaid provisions.

Answer

Rotation of Auditor & Cooling Off Period Provisions: The provision related to Rotation of Auditor & Cooling Off Period is newly inserted by section 139(2) of the Companies Act, 2013 read with Rule 5 of the Companies (Audit & Auditors) Rules, 2014, which is discussed as under:

The provisions related to rotation of auditor are applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014, which prescribes the following classes of companies excluding one person companies and small companies, namely:-

- (i) all unlisted public companies having paid up share capital of ₹ 10 crore or more;
- (ii) all private limited companies having paid up share capital of ₹ 50 crore or more;
- (iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ₹ 50 crores or more.

As per Section 139(2) of the Companies Act, 2013, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

- (a) an individual as auditor for more than one term of 5 consecutive years; and
- (b) an audit firm as auditor for more than two terms of 5 consecutive years.

In the given case, Ram Ltd. is a private company having paid up share capital of ₹ 5 crore and public borrowings of ₹ 100 crore. The company has appointed M/s Shyam & Co., a chartered accountant firm, as the statutory auditor in its AGM held at the end of September, 2019 for 11 years.

The provisions relating to rotation of auditor will be applicable as the public borrowings exceeds ₹ 50 crore. Therefore, Ram (P) Ltd. can appoint M/s Shyam & Co. as an auditor of the company for not more than one term of five consecutive years twice i.e. M/s Shyam & Co. shall hold office from the conclusion of this meeting upto conclusion of sixth AGM to be held in the year 2024 and thereafter can be re- appointed as auditor for one more term of five years i.e. upto year 2029. The appointment shall be subject to ratification by members at every annual general meeting of the company. As a result, the appointment of M/s Shyam & Co. made by Ram Ltd. for 11 years is void.

Question 22

KSY & Co., Chartered Accountants, is an audit firm having two partners CA K and CA Y. KSY & Co. is already holding appointment as auditors of 36 public companies and none of the partners hold any company audits in their personal capacity or as partners with another firm.

KSY & Co. seeks your advice in the following situations:

- (i) KSY & Co. has been offered the appointment as Auditors of 7 more Private Limited Companies. Of the seven, one is a company with a paid up share capital of ₹ 150 crores, five are "Small companies" as per the Act and one is a "Dormant Company".

- (ii) Would your answer be different, if out of those 7 Private Companies, 3 Companies have paid up capital of ₹ 90 crores each?

Answer

Ceiling Limit for Holding Company Audits: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore.

In the instant case, KSY & Co. is an audit firm having two partners, namely, CA. K and CA. Y. The total number of company audits that can be accepted by the firm is 40 (2 partners x 20 companies each partner). However, the firm is already holding appointment as auditors of 36 public companies. Thus, the remaining number of audits that can be accepted by the firm is of 4 more companies.

- (i) In the given situation, KSY & Co. has been offered appointment as auditors of 7 private limited companies out of which 1 is a private limited company with paid-up share capital of ₹ 150 crores, 5 are 'small companies' and 1 is 'dormant company'.

In view of above discussed provisions and explanations, KSY & Co. can hold appointment as an auditor in 5 'small companies' and 1 'dormant company' as these are excluded from the ceiling limit of company audits.

In addition, the firm can also accept appointment as auditor of 1 private limited company with paid-up share capital of ₹ 150 crores which will be within the maximum ceiling limit of 40 company audits.

Therefore, KSY & Co. can accept appointment for all the 7 private limited companies as asked in question.

- (ii) No, answer will not be different in the given situation, where KSY & Co. has been offered appointment as auditors of 7 private limited companies out of which 3 companies have paid-up share capital of ₹ 90 crores.

In view of above discussed provisions and explanations, KSY & Co. can hold appointment as an auditor in all the private companies as 3 private companies are having paid-up share capital of ₹ 90 crores which are exempted as per the provisions of the Companies Act, 2013, therefore, excluded from the ceiling limit of company audits and other 4 private companies will also be within the maximum ceiling limit of 40 company audits even if the paid-up share capital is ₹ 100 crore or more.

Question 23

"ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.

- (i) Provide the maximum number of Audits remaining in the name of "ABC & Co."
(ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.

- (iii) Can ABC & Co. accept the appointment as an auditor in 60 private companies having paid-up share capital less than ₹ 100 crore which has not committed default in filing its financial statements under section 137 or annual return under section 92 of the Companies Act with the Registrar, 2 small companies and 1 dormant company?
- (iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?

Answer

Fact of the Case: In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar).

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be $3 \times 20 = 60$ company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

- (i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm	$= 20 \times 3$	$= 60$
Number of Audits already taken by all the partners		
In their individual capacity	$= 4+6+10$	$= 20$
Remaining number of Audits available to the Firm		$= 40$

- (ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) Mr. A can hold: $20 - 4 = 16$ more audits. (2) Mr. B can hold $20-6 = 14$ more audits and (3) Mr. C can hold $20-10 = 10$ more audits.
- (iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar), 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.
- (iv) As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores (private company which has not committed a default in

filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar). In the given case, out of the 60 private companies ABC & Co. is offered, 45 companies having paid-up share capital of ₹ 110 crore each.

Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar.) and 40 private companies having paid-up share capital of ₹ 110 crore each in addition to above 20 company audits already holding.

Question 24

“PQRST & Co.” is an Audit Firm having partners “Mr. P”, “Mr. Q”, “Mr. R”, “Mr. S” and “Mr. T”, Chartered Accountants. “Mr. P”, “Mr. Q”, “Mr. R”, “Mr. S” and “Mr. T” are holding appointment as an Auditor in 4, 5, 6, 10 and 15 Companies respectively.

- (i) Provide the maximum number of Audits remaining in the name of “PQRST & Co.”
- (ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. “Mr. P”, “Mr. Q”, Mr. R, Mr. S and Mr. T.
- (iii) Can PQRST & Co. accept the appointment as an auditor in 80 private companies having paid-up share capital less than ₹ 100 crore which has not committed default in filing its financial statements under section 137 or annual return under section 92 of the Companies Act with the Registrar, 2 small companies and 1 dormant company?
- (iv) Would your answer be different, if out of those 80 private companies, 65 companies are having paid-up share capital of ₹ 115 crore each?

Answer

Fact of the Case: In the instant case, Mr. P is holding appointment in 4 companies, Mr. Q is holding appointment in 5 companies, Mr. R is holding appointment in 6 companies, whereas Mr. S is having appointment in 10 Companies and Mr. T is having appointment in 15 Companies. In aggregate all five partners are having 40 audits.

Provisions and Explanations: As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹ 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar).

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 5 partners, the overall ceiling will be $5 \times 20 = 100$ company audits. Sometimes, a Chartered Accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

Company Audit

- (i) Therefore, PQRST & Co. can hold appointment as an auditor of 60 more companies:
- | | | |
|--|---------------|-------|
| Total Number of Audits available to the Firm | = 20*5 | = 100 |
| Number of Audits already taken by all the partners | | |
| In their individual capacity | = 4+5+6+10+15 | = 40 |
| Remaining number of Audits available to the Firm | | = 60 |
- (ii) With reference to above provisions, an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence
- (1) Mr. P can hold: $20 - 4 = 16$ more audits.
 - (2) Mr. Q can hold: $20 - 5 = 15$ more audits.
 - (3) Mr. R can hold: $20 - 6 = 14$ more audits.
 - (4) Mr. S can hold $20 - 10 = 10$ more audits and
 - (5) Mr. T can hold $20 - 15 = 5$ more audits.
- (iii) In view of above discussed provisions, PQRST & Co. can hold appointment as an auditor in all the 80 private companies having paid-up share capital less than ₹ 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar), 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.
- (iv) As per fact of the case, PQRST & Co. is already having 40 company audits and they can accept only 60 more company audits. In addition, they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ₹ 100 crores (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar). In the given case, out of the 80 private companies PQRST & Co. is being offered, 65 companies have paid-up share capital of ₹ 115 crore each.

Therefore, PQRST & Co. can accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar.) and 60 private companies having paid-up share capital of ₹ 115 crore each in addition to above 40 company audits already held.

Question 25

C Ltd. appointed CA Innocent as a statutory auditor for the company for the current financial year. Further the company offered him the services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors. As an auditor, how would you deal in above situation.

Answer

Services not to be Rendered by the Auditor: Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of

Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services;
- (v) investment advisory services;
- (vi) investment banking services;
- (vii) rendering of outsourced financial services;
- (viii) management services; and
- (ix) any other kind of services as may be prescribed.

Further section 141(3)(i) of the Companies Act, 2013 also disqualify a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

In the given case, CA Innocent was appointed as an auditor of C Ltd. He was offered additional services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors. The auditor is advised not to accept the services as these services are specifically notified in the services not to be rendered by him as an auditor as per section 144 of the Act.

Question 26

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?

Answer

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:

- (i) Ceiling limit: Ensure that a certificate has been issued under section 139 of the Companies Act, 2013 so that the total number of company audits held by the firm (including the new appointment) will not exceed the specified number.
- (ii) 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.
- (iii) Compliance with law: Satisfy that the legal procedure contemplated in section 139 and 140 of the said Act, dealing with the appointment and removal of existing auditor, have been followed. Also check whether section 139(5) and 139(7) (in case of a government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments- appointment by the Comptroller and Auditor General of India) are attracted and complied with.
- (iv) Code of conduct: Communicate with the previous auditor, if any, in writing, to ascertain if there are any professional reasons for not accepting the appointment.

Question 27

Subject to the provisions of sub-rule (1) of Rule 3 of The Companies (Audit and Auditors) Rules, 2014 where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

Explain manner and procedure of selection and appointment of auditors as per Rule 3 of CAAR 2014.

Answer

Rule 3 of CAAR 2014 prescribes the following manner and procedure of selection and appointment of auditors.

- (1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

- (2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.
- (3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.
- (4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- (5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- (6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- (7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

Question 28

The Auditor of M/s Quick Limited succumbed to the pressure of the management in certifying the financials with an over stated figure of turnover by not adhering to the cut-off principles of the time scale for the transactions of the year. On taking cognizance of this act of the auditor, the Tribunal under the Companies Act, 2013 initiated the proceedings against him. Briefly list the powers of the Tribunal in this respect including those relating to making orders against the Auditor found to be guilty.

Or

On the advice of Management of Quick Ltd., the auditor of the Company overlooked and did not report on shifting of certain current year's sales transactions to the next year. The National Company Law Tribunal (NCLT) wants to take action against the auditor. Describe the powers of the NCLT under Section 140(5) of the Companies Act, 2013 for such action and consequences for the auditor.

Answer

Power of Tribunal in case Auditor acted in a Fraudulent Manner: As per sub-section (5) of the section 140 of the Companies Act, 2013, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447 of the said Act.

It is hereby clarified that in the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

Question 29

CA. G, was appointed by DP Ltd., as Statutory Auditor. While doing the audit of DP Ltd., CA. G observed that certain loans and advances were made without proper securities; certain trade receivables and trade payables were adjusted inter se; and personal expenses were charged to revenue. As a company auditor comment on the, reporting responsibilities of CA. G.

Answer

Duty of Auditor to Inquire on certain matters: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor

is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) of the Companies Act, 2013 is worth considering and reproduced below:

“The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor’s Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1).”

Clause (a) of Section 143(1) requires the auditor to inquire: “Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members”.

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

If **trade receivables and trade payables** are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire “whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company”. This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards”.

Regarding **Personal Expenses**, Clause (e) of section 143(1) requires the auditor to inquire: “Whether personal expenses have been charged to revenue account”. The charging to revenue of such personal expenses, either on the basis of the company’s contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

Question 30

While conducting the audit of a limited company for the year ended 31st March, 2020, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

Answer

Provisions and Explanation: Section 143 of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

Conclusion: In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure and also consider modifying/ qualifying his report in an appropriate manner.

Question 31

In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were reimbursed. As an auditor, how would you deal with the same?

Answer

Reimbursement of Personal Expenses of Director:

All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorised both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 143(1)(e) of the Companies Act, 2013 wherein auditor has to inquire into whether personal expenses have been charged to revenue.

Question 32

Director of T Ltd. draws an advance of US\$ 200 per day in connection with the foreign trip undertaken on behalf of the company. On his return he files a declaration stating that entire advance was expended without any supporting or evidence. T Ltd. books the entire expenses on the basis of such declaration. As the auditor of T Ltd. how do you deal with this?

Answer

SA 500 “Audit Evidence” states that an auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base his opinion.

Section 143(1)(e) the Companies Act, 2013 requires an auditor to enquire whether personal expenses have been charged to revenue account.

In the context of the facts of case, ascertain whether the payment made by the company for the foreign trip form an “allowance” or “reimbursement”. An allowance is a fixed sum of money allowed on the basis of specified criteria. No evidence supporting the expenditure is required for

payment of allowance to the director. On the other hand, if the payment is reimbursement should be against actual expenditure.

The director concerned should provide proof of expenditure. Since the director has given only a declaration, the auditor should ascertain other relevant facts as to whether the advance paid is pursuant to the policy of the company which is based on approximate estimation of the expenditure normally incurred by a person of the status of a director and the same is applicable to persons of a similar status within the company. If the auditor considers the advance taken is reasonable then the declaration can be considered adequate, otherwise he may have to call for additional documentary evidences.

Question 33

A Ltd. is a Chennai based company. The total turnover of the company is ₹ 10 crores for the year 2019-20. The company has a branch office at an area which was recently affected by flood. The transportation services are not available due to destruction caused by flood. The branch office recorded turnover of ₹ 1,50,000 in the Financial Year 2019-20. No audit of branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. Comment.

Answer

Branch Audit: As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

In the given situation, A Ltd. is a Chennai based company, having total turnover of ₹ 10 Crore. The company is having a branch office at an area which is recently affected by flood.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company's auditor is required to mention this fact in the audit report and deal appropriately. Thus, no reference of above branch in statutory auditor's report is not correct.

Question 34

Bhishm Limited decided to appoint Mr. Rajvir, chartered accountant, as the branch auditor for the audit of its Lucknow branch accounts for the year 2019-20. The decision to appoint branch auditor was taken by way of Board Resolution in the meeting of Board of Directors of the company, held in April 2019, subject to shareholders' approval in AGM of the company scheduled to be held in June 2019. Meanwhile, the Principal Auditor of the company raised an objection that the branch auditor cannot be appointed without his consent. Advise, whether the objection raised by company auditor is valid.

Answer

Appointment of Branch Auditor: Section 143 (8) of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the

branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139.

In case of subsequent appointment of auditor, section 139(1) of the Act provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting.

In the instant case, Bhishm Limited decided to appoint Mr. Rajvir, chartered accountant, as the branch auditor for the audit of its Lucknow branch accounts and the decision to appoint branch auditor was taken by way of Board Resolution in the meeting of Board of Directors of the company subject to shareholders' approval in AGM of the company.

Thus, objection raised by company auditor is not valid as per section 143(8) of the companies Act, 2013 and the Board has authority to appoint branch auditor but should be approved by shareholders in General Meeting.

Question 35

RAJ Ltd has a branch office which maintains its separate set of books of accounts. The statutory audit of RAJ Ltd and its branch office is conducted by two separate firms of Chartered Accountants. RAJ Ltd being the company with Head Office, its statutory auditors, always intervene in the work of the statutory auditors of branch office. Due to this, the audit completion takes longer period. Due to the company's internal policies, they need to continue with two separate auditors for head office and branch office. Please explain the aspects related to reporting and responsibilities of parent auditor (auditor of HO) and branch office auditors.

Answer

Sub-section (8) of Section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under Companies Act, 2013 or by any other person qualified for appointment as an auditor of the company under Companies Act, 2013 and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

The branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per Rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective

audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in SA 600, "Using the Work of another Auditor". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Question 36

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

P Ltd. of whom you are the Statutory Auditor appoints M/s XYZ as Branch Auditors for one of its branches. M/s XYZ conducted the audit of the branch without visiting the branch and instead getting the books at the H.O. M/s XYZ has submitted their Branch Audit Report to you.

Answer

Branch Auditor's Report: As per provisions of the Companies Act, 2013, the accounts of a branch office of a company are required to be audited either by the company's auditor or by any other person qualified for appointment as auditor of the company. It is not necessary for branch auditor M/s XYZ to visit the branch and conduct the audit only at branch's premises. It is a matter of professional judgement for the branch auditor to decide as to whether he needs to visit the branch.

At the same time, the statutory auditor has the right to visit branch offices and to have access to the books of accounts and vouchers maintained at the branch office in this case.

In any case, the principal auditor i.e. the statutory auditor of Head Office P Ltd. is entitled to rely on the work of branch auditor unless there are special circumstances to make it essential for him to visit the branch and examine the books of account and voucher records. As per basic principles governing an audit, the principal auditor is entitled to rely upon the work performed by others provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. As per SA 600, "Using the work of another auditor", the principal auditor

is not required to evaluate professional competence because branch auditor happens to be member of ICAI. The statutory auditor is also required to deal with the Branch Auditor's report in the manner, he considers necessary. Therefore, the statutory auditor is required to deal with M/s XYZ's report in the manner it considers fit under the circumstances.

Question 37

In the books of accounts of M/s OPQ Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year. As a Statutory Auditor, how would you deal?

Answer

Difference between Control Accounts and Subsidiary Records: The huge differences found between control accounts and subsidiary records in the books of M/s OPQ Ltd. indicate that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements. As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit.

Question 38

Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of ₹ 10 crores. The company has ₹ 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons.

Answer

Application of Share Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. Sub-section (1) of the said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to an account called "Securities Premium Account" and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company. Sub-section (2) of the said section provides that notwithstanding anything contained in sub-section (1), securities premium account may be applied by the company for issue of bonus

shares; writing off the preliminary expenses; writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; in providing for the premium payable on redemption of any redeemable preference shares or any debentures of the company; for the purchase of its own shares or other securities. In view of these provisions of the Companies Act, 2013, it is not permitted to adjust its accumulated losses against the securities premium account.

Question 39

Pirana Ltd. issued 10,000 shares of face value of ₹ 10 each at a premium of ₹ 490 each in May, 2019. The company received the stated minimum amount in the prospectus and transferred a sum equal to the aggregate amount of the premium received on shares (i.e. ₹ 49 lakhs) to the 'Securities Premium Account'. Unfortunately, in the month of July, the godown of the company caught fire and stock worth ₹ 45 lakhs burnt to ashes.

Now, the management desires to adjust the loss due to fire against the said premium account. Comment.

Answer

Application of Securities Premium Account: Section 52 of the Companies Act, 2013 (herein after referred as the Act) deals with the application of premium received on issue of shares. The said section provides that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to an account called "Securities Premium Account" and the provisions of this Act relating to reduction of share capital of a company except as provided in this section shall apply as if the securities premium account was the paid up share capital of the company.

However, as per section 52, the securities premium account may be applied for the following purposes:

- (i) towards the issue of fully paid bonus shares;
- (ii) in writing off the preliminary expenses;
- (iii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures;
- (iv) in providing for the premium payable on the redemption of any redeemable preference shares or debentures; or
- (v) for the purchase of its own shares or other securities under section 68 of the Companies Act, 2013.

In the given case, the management of Pirana Ltd. desires to adjust the loss due to fire against the securities premium account.

In view of the above provisions of the Companies Act, 2013, it may be noted that the company is not permitted to adjust its loss against the securities premium account.

Question 40

For the year ended on 31st March, 2020, P Ltd. proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves. Its auditor objected to the same stating that 10% is the maximum permissible limit to transfer to reserves.

Answer

Transfer to Reserve: Section 123(1) of the Companies Act, 2013 provides that dividend cannot be declared or paid by a company for any financial year except out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Section 123(2), or out of the profits or the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or out of both.

However, the first proviso to section 123(1) of the said Act provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, P Ltd. has proposed to pay a dividend of 25% on its equity shares and it further proposed to transfer 20% of Net profit for that year after tax to its reserves.

Therefore, from the above facts and provisions, it may be concluded that P Ltd. is under no violation of law i.e. the company is free to transfer any amount of its profit to the reserves, without any compulsion or restriction, before declaration of any dividend.

Question 41

ABC Limited is in the practice of maintaining consistent dividend payment over a minimum of 14%. The Financial year 2019-20 was so very bad for the Company that it was not possible for the Company to maintain the payment of consistent dividend as above. The Management, being hopeful of recovery of its performance in next year, felt that the depreciation of the year to the extent of 75% alone be charged to the Statement of Profit and Loss and the remaining 25% be kept in a separate account code in the Balance Sheet- 'Debit Balances Adjustable against Revenue account'. The Management was of the view that it would be in fair practice of accounting if the depreciation for asset is charged before the expiry of the lives of assets and the amount parked in asset code as above would unfailingly be adjusted to Revenue before the close of next financial year anyway. Analyse the issues involved and state how the Auditor should decide on this matter.

Answer

Provision of Depreciation :Section 123(1) of the Companies Act, 2013 provides that dividend cannot be declared or paid by a company for any financial year except out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Section 123(2), or out of the profits or the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or out of both. Further, it is the duty of auditor to check whether the depreciation was provided according to provision of AS 10 / IND AS 16/Schedule II to the Act.

In the instant case, ABC Limited is in the practice of maintaining consistent dividend payment over a minimum of 14%. Due to bad financial condition, company has not provided for dividend for the year 2019-20. In addition to this management has also taken decision to charge 75% of the depreciation in the statement of Profit and Loss whereas 25% of the depreciation amount kept in a separate account code in the Balance Sheet – ‘Debit Balances Adjustable against Revenue Account’.

Contention of management that it would be in fair practice of accounting where the depreciation of asset is charged before the expiry of the life of assets and the amount parked in asset code would unfaithfully be adjusted to revenue before the close of next financial year is not tenable.

The practice of the company in not charging the depreciation and accumulating 25% of it in a debit balance for being written off in the next year is not an acceptable accounting treatment. If dividend is declared in such situation, it would mean payment out of capital.

Therefore, the auditor of the company should ensure the compliance of provisions of section 123 and Schedule II. In case the management does not comply with the provisions and does not charge the 100% depreciation the auditor of the company shall suggest the management for the same and if management refuses, the auditor should qualify his report accordingly.

Question 42

IT Limited has prepared the financial statements for the year 2019-20 and mentioned in the significant accounting policies that depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management. The company has ignored the useful lives of assets mentioned in Schedule II of the Companies Act, 2013. As statutory auditor of the company how would you deal with this?

Answer

Providing Depreciation ignoring Schedule II to the Companies Act, 2013: Section 129 of the Companies Act, 2013, requires that the financial statements shall give a true and fair view of the state of affairs of the company and are in compliance with Accounting Standards.

Further, as per Schedule II to the Companies Act, 2013 on ‘Useful Lives to Compute Depreciation’, the useful life of an asset shall not ordinarily be different from the useful life specified therein.

However, if such a company uses a useful life of the asset which is different from the above limits, it shall disclose the justification for the same in its financial statement.

In the given case, IT Limited has mentioned in the significant accounting policies that the depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management and ignored the useful lives of the assets as provided under Schedule II to the Companies Act, 2013.

Therefore, the statutory auditor of the company should ensure that the management has disclosed the justification for consideration of different useful life of the assets from that as indicated under Schedule II. If the justification has not been provided then the auditor of the company shall suggest the management for the same and if management refuses, the auditor should qualify his report accordingly.

Question 43

IFFCO Company follows the method of providing depreciation as per Section 123 of the Companies Act, 2013 using the useful lives prescribed as per Schedule II of the Companies Act, 2013. It has provided depreciation on computers which are used during all the 3 shifts using the rates stipulated for continuous process plant since these assets are used for 24 hours (3 shifts).
Comment.

Answer

IFFCO Company followed the method of providing depreciation as per section 123 of the Companies Act, 2013 using the useful lives prescribed as per Schedule II of the Companies Act, 2013 is correct, however, they have provided depreciation using the rates stipulated for continuous process plant is not correct.

As per Schedule II Computers does not fall in continuous process plant category. Further, computers are included as NESD in Part 2 of Schedule II, which is category of assets in respect of which no extra shift depreciation is permitted.

Therefore, though computers are used for 24 hours i.e. triple shift but no extra shift depreciation is permitted on the same. In the instant case, the Company has provided depreciation on computers which are used during all the 3 shifts using the rates stipulated for continuous process plant as per its accounting policy is incorrect and would be misleading resulting into material misstatement and hence impacting true and fair view.

The auditor, therefore, should discuss with the management to make necessary changes in respect of same and if not agreed to, the auditor may qualify the report accordingly.

Question 44

As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit?

Answer

The auditor may take the following steps to ensure that the dividend has been paid only out of profits:

1. Check whether the dividend was declared out of profits arrived at after providing for depreciation as per Section 123(2) of the Companies Act, 2013 (herein after referred as the Act).
2. Check whether-
 - (i) the depreciation was provided according to provision of Schedule II to the Act.
 - (ii) a board resolution recommending dividend was passed.
 - (iii) the dividend was declared only in the Annual General Meeting.
 - (iv) no dividend declared in general meeting exceeds the amount recommended by the Board.
 - (v) amount paid or credited as paid on a share in advance of calls is not treated for the purpose of this regulation as paid on the share.
 - (vi) register of members was closed as per the provisions of section 91 of the Act.
 - (vii) dividend has been paid in the prescribed manner within 30 days of time to the registered holder or their order for the compliance of Section 127 of the Act.
 - (viii) Amount of dividend deposited in a separate bank account within five days from the date of declaration of dividend.

- (ix) intimation sent to Stock Exchange in the case of listed company.
- (x) were there any complaints of non-payment/delayed payment of dividend? If so, whether corrective action was taken.

Question 45

AARK Ltd is a large-sized listed company having annual turnover of INR 4000 crores. The company also has a plan to get listed on New York Stock Exchange next year. The company has paid good amount of dividend during the year to its shareholders which is significantly higher as compared to earlier years. The statutory auditors would like to focus on this aspect at the time of their statutory audit.

Please advise the relevant procedures that the statutory auditors should perform in respect of this area.

Answer

The Auditor should obtain appropriate audit evidence as regard to audit of payment of dividends. The procedures include the following:

- (i) Check that all the rules and regulations concerning the declaration or payment of dividends have been complied with.
- (ii) Examine that the accounting and disclosure procedure has been complied with related to the declaration and payment of dividend like depreciation has been provided before declaration, disclosure has been made by way of notes to the accounts etc.
- (iii) Scrutinize that the dividends have been declared or paid only out of distributable profit i.e. profits for the current year for which dividend is declared, or accumulated profits of the previous years, or money provided by the Central or State Government as per Section 123(1) of the Companies Act, 2013.
- (iv) Inspect that the dividend has been paid only out of “free reserves” i.e. the reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend except- any amount representing unrealized gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or any change in carrying amount of an asset or of a liability recognized in equity, including surplus in statement of profit and loss on measurement of the asset or the liability at fair value, as laid down under third proviso to Section 123(1) read with Section 2(43) of the Companies Act, 2013.
- (v) If dividend has been paid out of accumulated profits, earned by it in previous years and transferred to the reserves, in case of inadequacy or absence of profits in any financial years, verify that the rules related to such distribution has been complied i.e. the maximum amount allowable to be distributed as a dividend in case of inadequate or no profit as required by second proviso to Section 123(1) of the Companies Act, 2013.
- (vi) Verify that the dividend recommended by the Board has been approved by the members at the annual general meeting.
- (vii) Verify that the dividend has been transferred to the separate scheduled bank account within 5 days from the declaration of such dividend as required by Section 123(4) of the Companies Act, 2013.
- (viii) Verify that the dividend has been paid within 30 days from the declaration. If in case the dividend has not been claimed or paid within 30 days from the declaration, verify that the unpaid or unclaimed dividend amount has been transferred to a special account called unpaid dividend account as per Section 124(1) of the Companies Act, 2013.
- (ix) Verify that the company has prepared a statement within a period of 90 days of making any

transfer of an amount to the Unpaid Dividend Account containing the names, their last known addresses and the unpaid dividend to be paid to each person, and have placed it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose as required under Section 124(2) of the Companies Act, 2013.

- (x) Check the procedures that have been followed for the payment of unclaimed dividend out of unpaid dividend account.
- (xi) Verify that, if any money transferred to Unpaid Dividend Account has remained unpaid or unclaimed for a period of 7 years from the date of such transfer then, whether it has been transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund established under section 125(1) of the Companies Act, 2013 and a statement regarding such transfer has also been sent to the authority which administers such fund.
- (xii) In case the company has outsourced the activity to the Service Organisation, check that all the compliances with laws, regulations, accounting and disclosure related to the dividends have been made appropriately.

Question 46

The Board of Directors of ACP Ltd. has recommended the dividend of 15% on paid up share capital of ₹ 450 crore for the year ended 31st March, 2020, at their meeting held on 1st of May, 2020 when the accounts for the financial year 2019-20 were approved. The Board of Directors when they met on 7th July, 2020 for the review of first quarter accounts, they realized that results were negative for the first quarter. Therefore, the Board has decided to rescind their decision to recommend dividend.

The notice for AGM to be held on 14.8.2020 was sent on 15th July, 2020 without any recommendation for dividend.

At the AGM, the members asked the management how they can rescind the declaration of dividend once recommended. Comment.

Answer

Decision to rescind the Recommended Dividend: Dividend is firstly recommended by the Board. Thereafter, the members in the Annual General Meeting (AGM) may declare the dividend by passing ordinary resolution. The members may reduce the rate or amount recommended by the Board, but they cannot increase it.

Section 123 of the Companies Act, 2013, provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in prescribed manner.

Further, as per section 127 of the Act, dividends once declared become the liability of the company and must be paid within 30 days from the date of declaration. Any failure to do so attract a penalty for the various persons associated with the management.

Here in the instant case, Board of Directors of ACP Ltd. has recommended the dividend in their meeting. Such dividend is not declared in AGM. Further, Board has decided to rescind the decision before the date of Annual General Meeting. Thus, the dividend which is only recommended and not declared does not attract penal provisions.

Therefore, Board of Directors may rescind their decision to recommend dividend.

Question 47

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

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.

Answer

- (a) Declaration of Interim Dividend: Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the Statement of Profit and Loss and out of profits of the financial year in which such interim dividend is sought to be declared. The amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend for the compliance of Section 123(4) of the said Act.

Based on Section 2(35) of the said Act, it can be said that since interim dividend is also a dividend, companies should provide for depreciation as required by Section 123 before declaration of interim dividend. However, the first proviso to Section 123(1) provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, the Board has decided to pay interim dividend @15% of the paid-up capital. Assuming that the company has complied with the depreciation requirement, the interim dividend can be declared without transferring such percentage of its profits as it may consider appropriate to the reserves of the company.

Question 48

When can a company be said to have 'Not maintained' proper books of account? What is the role of the statutory auditor for the same?

Answer

Proper Books of Account Not Maintained: Section 128(1) of the Companies Act, 2013 requires that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

The provisions mentioned above are required to be followed by the company to maintain proper books of accounts. The Auditor is required to check that the company has complied with all the provisions related to maintenance of books of accounts etc.

Further, the books have to be maintained under accrual system and if the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

According to Section 143(3)(b), the auditor's report shall also state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.

If answer is in negative or with qualification, the report shall state the reasons there for.

Question 49

Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encashed and transferred to current accounts. As of 31st March, 2020 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment.

Answer

Presentation of Book Overdraft as per Schedule III to the Companies Act, 2013:

The instructions in accordance with which current assets being "cash and cash equivalents" should be made out to Part I of Schedule III to the Companies Act, 2013 states as follows:

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;
 - (c) Cash on hand;
 - (d) Others (specify nature).
- (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than 12 months maturity shall be disclosed separately.

From the facts of the case it is evident that in substance the position is that the composite bank balance including the balance in flexi deposit accounts are positive, even though physical set-off has not been made as on the balance sheet date. Further the bank has got the right to set off of flexi deposits against the cheques issued and hence it would be more informative and useful to the readers of the financial statements to disclose the book credit balance as a set-off from the flexi deposit accounts. The disclosure of the said book credit balance as book overdraft under the head current liabilities as proposed by the management is not correct.

Question 50

Comment on the following with reference to Schedule III to the Companies Act, 2013:

- (i) A company has disclosed performance guarantee and counter guarantees as Contingent Liabilities.

- (ii) The parent company has recognized in the current year's financial statement, dividend declared by its subsidiary after the balance sheet date.

Answer

- (i) A contingent liability in respect of guarantees arises when a company issues guarantees to another person on behalf of a third party e.g. when it undertakes to guarantee the loan given to a subsidiary or to another company or gives a guarantee that another company will perform its contractual obligations.

However, where a company undertakes to perform its own obligations, and for this purpose issues, what is called a "guarantee", it does not represent a contingent liability and it is misleading to show such items as contingent liabilities in the Balance sheet. For various reasons, it is customary for guarantees to be issued by Bankers e.g. for payment of insurance premia, deferred payments to foreign suppliers, letters of credit, etc. For this purpose, the company issues a "counter-guarantee" to its Bankers. Such "counter-guarantee" is not really a guarantee at all, but is an undertaking to perform what is in any event the obligation of the company, namely, to pay the insurance premia when demanded or to make deferred payments when due.

Hence, such performance guarantees and counter-guarantees should not be disclosed as contingent liabilities.

- (ii) The Schedule III does not prescribe to recognise dividend declared by subsidiary company as given in the scenario. Accordingly, dividend income from subsidiary companies should be recognised in accordance with AS-9, i.e. only when they have a right to receive the same on or before the Balance sheet date. Normally, the right to receive is established only when the dividend is approved by the shareholder at the AGM of the investee company. Therefore, treatment done by the company is not in order.

Question 51

As an auditor of a company registered under section 8 of the Companies Act, 2013 , you find that as per the notification of the Ministry of Corporate Affairs regarding applicability of Indian Accounting Standards (Ind-AS), the company has to prepare its financial statements for the year ended 31st March, 2020 under Ind-AS. The management of the company is, however, of the strong view that being a section 8 company having charitable objects, Ind-AS cannot apply to the company. The financial statements are, therefore, prepared by the management under the earlier GAAP and a note for the same is given in the financial statements. How would you report on these financial statements?

Answer

Applicability of IND AS: Section 129(1) of the Companies Act, 2013, governs the requirements to be satisfied by financial statements. The provisions thereunder which should be complied with are:

- financial statements shall, give a true and fair view of the state of affairs of the company or companies as at the end of financial year, comply with the notified accounting standards under section 133 and be in such form or forms specified in Schedule III to the Companies Act, 2013 and
- the items contained in such financial statements shall be in accordance with the accounting standards.

Further, as per **section 133 of the Companies Act, 2013**, the Central Government has notified

Companies (Indian Accounting Standards) Rules, 2015 dated 16.02.2015 in exercise of the powers conferred by section 133. The said rules list the Indian Accounting Standards (Ind AS) and the class of companies required to comply with the Ind AS while preparation of their financial statements.

Here, it may be noted that the companies covered under Section 8 are required to comply the provisions of the Companies Act, 2013, unless and until any exemption is provided. Therefore, **companies registered under Section 8 are not exempted from the requirements of section 133 and section 129 of the Companies Act, 2013.**

In the given case, only contention of management that being a section 8 company having charitable object, Ind-AS cannot apply to the company, therefore financial statements prepared under the earlier GAAP and a note for the same is given, is not tenable.

However, **the auditor is required to ensure the applicable monetary limits w.r.t Ind- AS** and need to advise the management to prepare the financial statements as per Ind-AS accordingly. In case of non-compliance the auditor should report accordingly.

Question 52

MG & Co. Ltd. seeks your advice while preparing financial statements the general instructional to be followed while preparing Balance Sheet under Companies Act, 2013 in respect of current assets and liabilities.

Answer

General Instructions for Preparation of Balance Sheet:

- (i) General Instruction in respect of Current Assets: An asset shall be classified as current when it satisfies any of the following criteria-
 - (1) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (2) it is held primarily for the purpose of being traded;
 - (3) it is expected to be realized within twelve months after the reporting date; or
 - (4) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.
- (ii) General Instruction in respect of Current Liabilities: A liability shall be classified as current when it satisfies any of the following criteria-
 - (1) it is expected to be settled in the company's normal operating cycle;
 - (2) it is held primarily for the purpose of being traded;
 - (3) it is due to be settled within twelve months after the reporting date; or
 - (4) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

Question 53

The Balance Sheet of G Ltd. as at 31st March, 20 is as under. Comment on the presentation in terms of Division I and Division II of Schedule III.

Heading	Note No.	31 st March, 20	31 st March, 19
Equity & Liabilities			
Share Capital	1	XXX	XXX
Reserves & Surplus	2	0	0
Employee stock option outstanding	3	XXX	XXX
Share application money refundable	4	XXX	XXX
Non-Current Liabilities		XXX	XXX
Deferred tax liability (Arising from Indian Income Tax)	5	XXX	XXX
Current Liabilities			
Trade Payables	6	XXX	XXX
Total		<u>XXXX</u>	<u>XXXX</u>
Assets			
Non-Current Assets			
Fixed Assets-Tangible	7	XXX	XXX
CWIP (including capital advances)	8	XXX	XXX
Current Assets			
Trade Receivables	9	XXX	XXX
Deferred Tax Asset (Arising from Indian Income Tax)	10	XXX	XXX
Debit balance of Statement of Profit and Loss		XXX	XXX
Total		<u>XXXX</u>	<u>XXXX</u>

Answer**Following Errors are noticed in presentation as per Division I of Schedule III:**

- (i) Share Capital and Reserve & Surplus are to be reflected under the heading "Shareholders' funds", which is not shown while preparing the balance sheet. Although it is a part of Equity and Liabilities, yet it must be shown under head "shareholders' funds". The heading "Shareholders' funds" is missing in the balance sheet given in the question.
- (ii) Reserve & Surplus is showing zero balance, which is not correct in the given case. Debit balance of statement of Profit & Loss should be shown as a negative figure under the head 'Surplus'. The balance of 'Reserves and Surplus', after adjusting negative balance of surplus shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.
- (iii) Schedule III requires that Employee Stock Option outstanding should be disclosed under the heading "Reserves and Surplus".
- (iv) Share application money refundable shall be shown under the sub-heading "Other Current Liabilities". As this is refundable and not pending for allotment, hence it is not a part of equity.
- (v) Deferred Tax Liability has been correctly shown under Non-Current Liabilities. But

Deferred tax assets and deferred tax liabilities, both, cannot be shown in balance sheet because only the net balance of Deferred Tax Liability or Asset is to be shown if the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and it relates to the same governing tax laws.

- (vi) Under the main heading of Non-Current Assets, Property, Plant and Equipment are further classified as under:
- (a) Tangible assets
 - (b) Intangible assets
 - (c) Capital work in Progress
 - (d) Intangible assets under development.

Keeping in view the above, the CWIP shall be shown under Property, Plant and Equipment as Capital Work in Progress. The amount of Capital advances included in CWIP shall be disclosed under the sub-heading "Long term loans and advances" under the heading Non-Current Assets.

Subsequent to the notification of Ministry of Corporate Affairs dated October 11, 2018 under Section 467(1) of the Companies Act, 2013, the words "Fixed assets" shall be substituted with the words "Property, Plant and Equipment".

- (e) Deferred Tax Asset shall be shown under Non-Current Asset. It should be the net balance of Deferred Tax Asset after adjusting the balance of deferred tax liability if the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and it relates to the same governing tax laws.
- (f) Subsequent to the notification of Ministry of Corporate Affairs dated October 11, 2018 under Section 467(1) of the Companies Act, 2013, Trade Payables should be disclosed as follows:-
- (A) total outstanding dues of micro enterprises and small enterprises; and
 - (B) total outstanding dues of creditors other than micro enterprises and small enterprises."

Following Errors have been noticed in presentation, as per Division II of Schedule III:

- (i) Balance sheet should begin with Assets on top and then, Equity and Liabilities should be presented.
- (ii) Under the main heading of Non-Current Assets, following sub-headings are provided in the format as per Division II:
- (a) Property, plant and equipment
 - (b) Capital work-in-progress

In view of the above, the Fixed asset- Tangible should be presented as "Property, Plant and Equipment". CWIP should be presented as "Capital Work in Progress". Under Ind AS Schedule III, 'Capital Advances' are not to be classified under 'Capital Work in Progress', since they are specifically to be disclosed under 'Other non-current assets' .

- (iii) Deferred Tax Asset should be presented under "Non-Current Asset". It should be the net balance of Deferred Tax Asset, after adjusting the balance of deferred tax liability, if the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and it relates to the same governing tax laws.
- (iv) Trade receivables shall be presented under sub-heading "Financial assets" under heading "Current Assets".

- (v) Share capital and Reserves & Surplus need to be presented under the heading "Equity". The heading Equity is missing in the balance sheet given in the question. Reserves & Surplus would form part of sub-heading "Other Equity" in the notes to accounts and such balance of "Other Equity" would be presented on face of balance sheet under the heading "Equity".
- (vi) Debit balance of statement of profit and loss would be presented as negative balance under "Retained Earnings" in sub-heading "Other Equity" in the notes to accounts. Such balance of "Other Equity" even if negative, would be presented on face of balance sheet under the heading "Equity".
- (vii) Division II of Schedule III requires that Employee Stock Option outstanding should be disclosed under the sub-heading "Other Equity" in the notes to accounts which should be presented on face of balance sheet under the heading "Equity".
- (viii) Share application money refundable should be presented under the sub-sub- heading "Other Financial Liabilities" under the sub-heading "Financial Liability". As this is refundable and not pending for allotment, hence, it should not form part of equity.
- (ix) Deferred Tax Liability has been correctly presented under "Non-Current Liabilities". But Deferred tax assets and deferred tax liabilities, both, cannot be presented in balance sheet since only the net balance of Deferred Tax Liability or Asset is to be disclosed if the enterprise has a legally enforceable right to set off assets against liabilities representing current tax; and it relates to the same governing tax laws.
- (x) Trade payables should be presented under sub-heading "Financial liabilities" under the heading "Current liabilities". Subsequent to notification by Ministry of Corporate Affairs dated October 11, 2018 under Section 467(1) of the Companies Act, 2013, Trade Payables should be disclosed as follows:
 - (A) total outstanding dues of micro enterprises and small enterprises; and
 - (B) total outstanding dues of creditors other than micro enterprises and small enterprises.

Question 54

As an Auditor give your comments for the following disclosures made by a Company which adopted Ind AS for compilation of Financial Statements:

- (i) In the Balance Sheet, the sub-head inventories contained an item "goods in transit" in which a consolidated amount aggregating the cost of raw materials in transit and loose tools billed on company but delivery not made to company had been specified.
- (ii) Provision for doubtful debts of trade debtors was grouped in, "Provisions" under current liabilities.
- (iii) In Statement of Profit and Loss, prior period income was shown under "Other Income".
- (iv) Sale proceeds of scrap incidental to manufacture were included in "Other Income".
- (v) Payment towards a one time voluntary retirement scheme introduced during the year was included in "Employee Benefit Expense".

Answer

- (i) **Goods in Transits:** As per Division II of Schedule III of the Companies Act, 2013, cost of raw material in transit shall be disclosed as sub-head of raw material and loose tools billed on the company would be shown as separate sub-head of Loose tools under heading of Inventories i.e. part of Current Asset. Thus, disclosure of consolidated amount aggregating

the cost of raw material in transit and loose tools is not correct.

- (ii) **Provision for Doubtful Debts of Trade Debtors was grouped in “Provisions” under current liabilities:** The term ‘doubtful debts’ is an adjustment to the carrying amounts of assets, hence no provision is created separately for it as per Ind-AS 37 “Provisions, Contingent Liabilities and Contingent Assets”. Thus, provision should be shown net in trade receivable.
- (iii) **In Statement of Profit and Loss, Prior Period Income was shown under Other Income:** As per Ind-AS 8 “Accounting Policies, Changes in Accounting Estimates and Errors”, Prior Period Income should not be shown in statement of profit and loss. The entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.
- (iv) **Sale Proceeds of Scrap incidental to manufacture were included in “Other Income”:** As per Ind-AS 2 “Inventories”, sale proceeds of scrap incidental to manufacture should be deducted from the cost of the main product. Thus, disclosure of sale proceeds of scrap as other income is not correct.
- (v) **Payment towards a one time VRS during the year included in Employee Benefit Expenses:** As per Ind-AS 19 “Employee Benefits”, if the termination benefits are expected to be settled wholly before twelve months after the end of the annual reporting period in which the termination benefit is recognized, the entity shall apply the requirements for short-term employee benefits, in case it is not expected to be settled before twelve months the entity shall apply the requirements for long term employee benefits. In the instant case, it should be shown as short term employee benefits in place of Employee Benefit Expenses. Thus, treatment of such payment as employee benefit expenses is not correct.

Question 55

The financial statements of MP Ltd. as on March 31, 2020 are to be prepared under Division II of Schedule III to the Companies Act, 2013. Comment on the disclosure compliances for MP Ltd. from the following information in the financial statements which are required to be drawn up in compliance with Ind AS.

- (i) Property, Plant and Equipment include ₹ 2.50 crore for a boiler-plant under construction.
- (ii) Cash and cash equivalents include ₹ 1.25 crore deposited with a nationalized bank on 31st March, 2020 for 18 months. It is shown under current assets.
- (iii) Non-current assets include under caption "Biological assets other than bearer Plants" a sum of ₹ 1.50 crore being cost of cultivation for bringing to yield level, the cashewnut trees whose yield period, according to estimate shall not be less than 10 years.

Answer

- (i) **Disclosure of Boiler Plant under Construction:** Boiler plant under construction should be shown under the heading ‘Capital works in Progress instead of Property Plant and Equipment. Thus, inclusion of value of boiler plant under construction in Property Plant and Equipment is not in order.
- (ii) **Disclosure of Cash and Cash Equivalents deposited with Nationalised Bank:** Bank deposits with more than 12 months maturity shall be disclosed under 'Other financial assets'. Therefore, disclosure of deposits rupees 1.25 crores in a nationalised bank for 18 months as Cash and Cash Equivalents is not in order as per Division II of Schedule III.
- (iii) **Disclosure of Cost of Cultivation for bringing to yield level the Cashewnut trees:** Cost

of 1.5 crore rupees for Cultivation for bringing to yield level, the cashewnut trees whose yield period is more than one period will form part of 'Bearer Plant'. Hence it will not be considered as 'Biological Assets other than bearer plant'. Therefore, it should be shown under the heading 'Property Plant and Equipment' as Bearer Plant as per Division II of Schedule III.

Question 56

Z Ltd. changed its employee remuneration policy from 1st April, 2019 to provide for 12% contribution to provident fund on leave encashment also. As per the leave encashment policy, the employees can either utilize or encash it. As at 31st March, 2020, the company obtained an actuarial valuation for leave encashment liability. However, it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution was made. The company further contends that this is the correct treatment as it is not sure whether the employees will avail leave encashment or utilize it. Comment in view of relevant IND-AS.

Answer

As per Para 13 of Ind AS-19 on "Employee Benefits", notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time, an entity shall recognize the expected cost of short-term employee benefits in the form of paid absences, when the employees render service that increase their entitlement to future paid absences.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the paid absences are accumulating in nature. An enterprise should measure the expected cost of accumulating paid absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, Z Ltd. will accumulate the amount of leave encashment benefits as it is the liability of the company to provide 12% PF on amount of leave encashment. Hence, the contention of the auditor is correct that full provision should be provided by the company.

Question 57

K Ltd. had 5 subsidiaries as at 31st March, 2020 and the investments in-subsidaries are considered as long term and valued at cost. Two of the subsidiaries had their net worth eroded as at 31st March 2020 and the prospects of their recovery are very bleak and the other three subsidiaries are doing exceptionally well. The company did not provide for the decline in the value of investments in two subsidiaries because the overall investment portfolio in subsidiaries did not suffer any decline as the other three subsidiaries are doing exceptionally well. Comment in view of relevant IND-AS.

Answer

As per Para 10 of Ind AS-27 on "Separate Financial Statements", notified under the Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time, when an entity prepares separate financial statements, it shall account for investments in subsidiaries, joint ventures and associates either at cost or in accordance with Ind AS 109.

In the given situation, K Ltd. has valued the investments in subsidiaries at cost.

Ind AS 36 “Impairment” deals with impairment of investments in subsidiaries accounted for at cost under Ind AS 27. **As per Para 9 of Ind AS 36**, an entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. It implies that impairment indicators for investment in subsidiaries is to be assessed by K Ltd. individually for each investment and not as group of investment.

As provided, two of the subsidiaries of K Ltd. has their net-worth eroded on 31st March XX and chances of recovery is bleak. As such, the indicators of impairment in value of investment in such two subsidiaries exist on reporting date.

Keeping in view the above, K Ltd. should provide for the impairment in the value of investments in two subsidiaries despite the fact that the other investments in subsidiaries did not suffer any impairment.

Question 58

Director (Finance) of Beta Ltd. is of the opinion that total trade payables mentioned in the financial statement is sufficient disclosure in the Balance Sheet as per Part I of Schedule III to the Companies Act, 2013. They did not mention details regarding Micro, Small and Medium Enterprises (MSME). Give your view as statutory auditor of the Company and state the details required to be disclosed in notes regarding MSME.

Answer

Details required to be disclosed in Notes regarding MSME: Opinion of Director (Finance) of Beta Ltd. that total trade payables mentioned in the financial statement is sufficient disclosure in the Balance Sheet as per Part I of Schedule III to the Companies Act, 2013, is not correct. The following details relating to Micro, Small and Medium Enterprises shall be disclosed by Beta Ltd. in the notes:

- (i) **the principal amount and the interest due** thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
- (ii) **the amount of interest paid by the buyer** as per Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;
- (iii) **the amount of interest due and payable** for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
- (iv) **the amount of interest accrued** and remaining unpaid at the end of each accounting year; and
- (v) **the amount of further interest remaining due** and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure as per Micro, Small and Medium Enterprises Development Act, 2006.

Question 59

X Ltd. paid 25 lakhs as advance to Y Ltd. towards the purchase of a printing machinery on 15.1.20 with delivery instructions to deliver the same in the last week of June, 20. Further on 2.2.20 X Ltd. purchased two diesel generator sets from Y Ltd. for ₹ 30 lakhs on 90 days Credit term. In the accounts for 2019-20, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of ₹ 5 lakhs as due from them. As the statutory auditor, how would you deal with this?

Answer

Adjustment of Advances: Since X Ltd. has paid advance amount to the supplier of machinery to be used in the project, such advance amount should be grouped under the head 'Capital Work in Progress'. This is as per requirement of Schedule III to the Companies Act, 2013 and the existing accounting practice.

If the advance is for purchase of other machinery, it should be grouped under a separate head – say 'Advance Payment for Capital Expenditure' and should be disclosed as next item to Fixed Assets in the Balance Sheet.

In view of the above, the proposal of X Ltd., to show the net balance in the personal account of Y Ltd., is not correct. Such proposal will conceal the two material items in the balance sheet – one, expenditure towards capital asset and the other current liability for purchase of the generator set.

Hence, the auditor should advise X Ltd. to show these two items separately. If X Ltd. does not accept the advice, the auditor should qualify his report with suitable quantification of amount involved.

Question 60

ABC Ltd., is consistently following Accounting Standards as required under section 133 of the Companies Act, 2013. During your tax audit under section 44AB of the Income Tax Act, 1961, the Board of Directors informed you that profits of the Company is properly arrived at and the Accounting Standards applicable to it have been followed consistently and as such, there need not be any adjustments to be made as per Income Computation and Disclosure Standards notified under section 145 of Income Tax Act, 1961. Based on the requirements of Law in this regard, examine the validity of the stand of Management in this regard.

Answer

Income Computation and Disclosure Standards (ICDS): Section 145 of the Income Tax Act, 1961 deals with the Method of Accounting: Under section 145(1), income chargeable under the heads "Profits and gains of business or profession" or "Income from other sources" shall be computed in accordance with either the cash or mercantile system of accounting regularly employed by the assessee.

Further, **Section 145(2)** empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assessee or in respect of any class of income.

Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assesses (other than an individual or a HUF who is not required to get his accounts of one previous year audited in accordance with the provisions of section 44AB), following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or "Income from other sources". from the A.Y. 2017-18.

In the instant case, ABC Ltd. is consistently following Accounting Standards in compliance with section 133 of the Companies Act, 2013 but not complying with the provisions of Income

Computation and Disclosure Standards notified under section 145 of the Income Tax Act, 1961. Contention of the management that they are following Accounting Standards and need not to make any adjustments as per ICDS, is not correct. Thus, ABC Ltd. is required to adjust the profits in compliance with ICDS.

Question 61

Beneath minerals Limited is a Public Sector Company engaged in extraction of minerals from land. It has to pump out water in the first layer of the soil if the minerals are to be excavated. The Company pumps out water and diverts the water through a water course constructed by it to nearby villages and the water is allowed to be used by villagers for drinking purposes. The cost of construction of water course amounted to ₹ 5.25 crores and the Company had disclosed this amount as CSR expenses in the Statement of Profit and Loss. Comment.

Answer

Corporate Social Responsibility Expenses: Company (Corporate Social Responsibility Policy) Rules, 2014 mandated the corporate entities that the expenditure incurred for Corporate Social Responsibility (CSR) should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

In the instant case, Beneath minerals Limited is a public sector company which is engaged in extraction of mineral from land, for that it has to pump out water in the first layer of the soil if the minerals are to be excavated. The company pumps out water and diverts the water through a water course constructed by it to nearby villages and the water is allowed to be used by villagers for drinking purposes. Company has disclosed the cost of construction of water course as CSR expenses in the statement of Profit and Loss, which is not correct as this expenditure incurred for the construction of water course is included in the ordinary course of activities of business.

Therefore, the treatment done by showing the cost of construction of water course as CSR expense is not correct.

Question 62

Pearl Ltd. is an exporter of precious and semi-precious stones. The turnover of the company is ₹ 150 crore, out of which ₹ 105 crore is from export business and remaining ₹ 45 crore from domestic sales. Amount received from export business is all in foreign currency. Directors of Pearl Ltd. are of the opinion that cost audit is not applicable to their company as maximum revenue has been generated from export business. Give your opinion.

Answer

Cost Audit Rules not to apply in certain cases: The requirement for cost audit shall not be applicable to a company whose revenue from exports, in foreign exchange, exceeds seventy-five per cent of its total revenue, which is operating from SEZ and which is engaged in the generation of electricity for captive consumption through captive generating plant. (as per Rule 3 of the Companies (Cost Records and Audit) Rules, 2014).

In the instant case, Pearl Ltd. is an exporter of precious and semi-precious stones and the turnover of the company is rupees 150 crore out of which rupees 105 crore i.e. 70% is from export business and remaining rupees 45 crore i.e. 30% from domestic sales. It is neither operating from SEZ nor involved in captive power generation.

Thus, opinion of director is not tenable as revenue from exports in foreign exchanges is below prescribed limit. Therefore, cost audit is applicable on Pearl Ltd. as per Rule 3 of the Companies (Cost Records and Audit) Rules, 2014. Pearl Ltd. has to appoint cost auditor to get the cost accounts

of the company audited.

Question 63

Petro Ltd. is engaged in generation of electricity for captive consumption through Captive Generating Plant. The Company also maintains cost records in its books of account as required under Cost Records and Audit Rules. Mr. Xylo, friend of Managing Director of the Company, suggested name of his brother, who is a Cost Accountant in Practice, for the purpose of cost audit. However, the statutory auditor of the company, is of the view that the Company is not legally required to conduct cost audit. Now, the Managing Director is in dilemma about the requirement of cost audit. Being an expert in cost records and audit rules, you are required to guide in this regard.

Answer

Applicability of Provisions related to Cost Records and Audit: The provisions relating to cost records and audit are governed by section 148 of the Companies Act, 2013 read with the Companies (Cost Records and Audit) Rules, 2014. The audit conducted under this section shall be in addition to the audit conducted under section 143.

Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, required to include cost records in their books of account.

However, the requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- (a) whose revenue from exports, in foreign exchange, exceeds 75 per cent of its total revenue; or
- (b) which is operating from a special economic zone.
- (c) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

In the given case, Petro Ltd. is engaged in generation of electricity for captive consumption through Captive Generating Plant. Therefore, Petro Ltd. is not required to conduct cost audit as it is falling under the exemption criteria. Hence, the opinion of statutory auditor of the Company regarding non-applicability of cost audit is correct.

Question 64

MKc LLP is a newly set up LLP (Limited Liability Partnership). The operations of the LLP have been picking up and management is currently in the process of setting up processes and procedures in place. As per the understanding of the management of the LLP, its accounts would not be required to be audited mandatory because of its operations but still the management has decided that they would get the accounts audited voluntarily. In this regard, the management would like to understand some of the aspects which they should consider not only limited to audit but also about the maintenance of books of accounts as per the relevant laws. Please advise.

Answer

An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. The accounts of every LLP shall be audited in accordance with Rule 24 of LLP Rules 2009. Such rules, inter-alia, provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule.

Appointment of Auditor: The auditor may be appointed by the designated partners of the LLP –

1. At any time for the first financial year but before the end of first financial year,
2. At least thirty days prior to the end of each financial year (other than the first financial year),
3. To fill the causal vacancy in the office of auditor,
4. To fill the casual vacancy caused by removal of auditor.
5. The partners may appoint the auditors if the designated partners have failed to appoint them.

LLPs are required to maintain books of accounts which shall contain -

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

The auditor should read the LLP agreement & note the following provisions

- (a) Nature of the business of the LLP
- (b) Amount of capital contributed by each partner
- (c) Interest – in respect of additional capital contributed
- (d) Duration of partnership
- (e) Drawings allowed to the partners
- (f) Salaries, commission etc payable to partners
- (g) Borrowing powers of the LLP
- (h) Rights & duties of partners
- (i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
- (j) Any loans advanced by the partners
- (k) Profit sharing ratio.

Question 65

M/s PC & Co., Chartered Accountants are the statutory auditors of various categories of companies and bodies corporate. In exercise of the powers conferred under sub-sections (2) and (4) of section 132, of the Companies Act, 2013 the Central Government made the National Financial Reporting Authority Rules, 2018 (NFRA Rules) (MCA Notification dated 13 November 2018). The audit firm seeks your guidance on the applicability of those categories of companies and bodies corporate which are covered by NFRA Rules.

Answer

As per NFRA rules, NFRA shall have power to monitor and enforce compliance with accounting standards and auditing standards, oversee the quality of service under sub-section (2) of section 132 or undertake investigation under sub-section (4) of such section of the auditors of the following class of companies and bodies corporate:

- (a) companies whose securities are listed on any stock exchange in India or outside India;
- (b) unlisted public companies having paid-up capital of not less than rupees five hundred crores or having annual turnover of not less than rupees one thousand crores or having, in aggregate, outstanding loans, debentures and deposits of not less than rupees five hundred crores as on the 31st March of immediately preceding financial year;
- (c) insurance companies, banking companies, companies engaged in the generation or supply of electricity, companies governed by any special Act for the time being in force or bodies corporate incorporated by an Act in accordance with clauses (b), (c), (d), (e) and (f) of section 1 (4) of the Companies Act, 2013;
“Explanation.- For the purpose of this clause, “banking company” includes ‘corresponding new bank’ as defined in clause (d) of section 2 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970) and clause (b) of section 2 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980) and ‘subsidiary bank’ as defined in clause (k) of section 2 of the State Bank of India (Subsidiary Bank) Act, 1959 (38 of 1959).”
- (d) any body corporate or company or person, or any class of bodies corporate or companies or persons, on a reference made to the NFRA by the Central Government in public interest; and
- (e) a body corporate incorporated or registered outside India, which is a subsidiary or associate company of any company or body corporate incorporated or registered in India as referred to in clauses (a) to (d) above, if the income or net-worth of such subsidiary or associate company exceeds 20% of the consolidated income or consolidated net-worth of such company or the body corporate, as the case may be, referred to in clauses (a) to (d) above.

CARO, 2016**Question 66**

Evolution Pvt. Ltd. borrowed a sum of ₹ 110 lakh from Banks and Financial Institutions, subsequently, the company defaulted in repayment of its loans, to the extent of 50%. The management of the company contends that that it being a private limited company, the Companies (Auditor's Report) Order [CARO], 2016 is not applicable.

You are required to state the list of companies to which CARO is not applicable and state whether it will be applicable on Evolution Pvt. Ltd.

Answer

Applicability of Companies (Auditor's Report) Order [CARO], 2016: The CARO, 2016 is an additional reporting requirement Order which has been issued by the Central Government in consultation with the Institute of Chartered Accountants of India under section 143(11) of the Companies Act, 2013.

The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013. However, the Order specifically exempts the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

In the given case, Evolution Pvt. Ltd. has outstanding loan of rupees 110 lakhs from Banks and Financial Institutions together, which is exceeding the limit prescribed under Order for applicability of exemption.

Therefore, CARO, 2016 will be applicable on Evolution Pvt. Ltd.

Question 67

E-Tech Pvt. Ltd., which has an aggregate outstanding loan of ₹ 20 lakhs from Banks and ₹ 30 lakhs from Financial Institutions, defaulted in repayment thereof to the extent of 50%. The company holds that it being a private limited company, the Companies (Auditor's Report) Order, 2016 is not applicable.

You are required to state the list of companies to which CARO is not applicable and state how would you deal with the given situation as an auditor of the company.

Answer

Applicability of Companies (Auditor's Report) Order, 2016 [CARO, 2016]: The CARO, 2016 is an additional reporting requirement Order which has been issued by the Central Government in consultation with the Institute of Chartered Accountants of India under section 143(11) of the Companies Act, 2013.

The order applies to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013. However, the Order specifically exempts the following class of companies-

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) a company licensed to operate under section 8 of the Companies Act;
- (iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and
- (v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

In the given case, E-Tech Pvt. Ltd. has outstanding loan of ₹ 50 lakhs (₹ 20 lakhs + ₹ 30 lakhs) from Banks and Financial Institutions together, which is not exceeding the limit prescribed under Order for applicability of exemption.

Therefore, contention of the E Tech Pvt. Ltd., is correct that CARO, 2016 will not be applicable on it.

Question 68

Astha Pvt. Ltd. has fully paid capital of ₹ 140 lakh. During the year, the company had borrowed ₹ 15 lakh each from a bank and a financial institution independently. It has the turnover (Net of excise ₹ 50 lakh which is credited to a separate account) of ₹ 475 lakh. Will Companies (Auditor's Report) Order, 2016 be applicable to Astha Pvt. Ltd.?

Answer

Applicability of CARO, 2016: The CARO, 2016 specifically exempts a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements

In the case of Astha Pvt. Ltd., it has outstanding loan of ₹ 30 lakh (₹ 15 lakh + ₹ 15 lakh) collectively from bank and financial institution which is less than ₹ 1 crore rupees and turnover is ₹ 4.75 crore i.e. also less than ₹ 10 crore and not exceeding the limit. However, it has paid capital of ₹ 140 lakh i.e. more than ₹ 1 crore.

Thus, in view of rupees 140 lakh paid up capital which is exceeding the prescribed limit for exemption, CARO, 2016 will be applicable to Astha Pvt. Ltd.

Question 69

T Pvt. Ltd.'s paid up Capital & Reserves are less than ₹ 50 lakhs and it has no outstanding loan exceeding ₹ 25 lakhs from any bank or financial institution. Its sales are ₹ 6 crores before deducting Trade discount ₹ 10 lakhs and Sales returns ₹ 95 lakhs. The services rendered by the company amounted to ₹ 10 lakhs. The company contends that reporting under Companies Auditor's Reports Order (CARO) is not applicable. Discuss.

Answer

Applicability of CARO, 2016: The CARO, 2016 specifically exempts a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

In the given case, paid up capital and reserves of T Pvt. Ltd. is less than ₹ 1 crore and has no loan outstanding exceeding ₹ one crore from any bank or financial institution. Further, its total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) is not exceeding rupees ten crore during the financial year as per the financial statements.

Thus CARO 2016 will not be applicable to T Pvt. Ltd.

Question 70

A Term Loan was obtained from a bank for ₹ 80 lakh for acquiring R&D equipment, out of which ₹ 15 lakh was used to buy a car for use of the concerned director who was overlooking the R&D activities. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

Utilisation of Term Loans: According to clause (ix) of Para 3 of CARO, 2016, the auditor is required to report "whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default & subsequent rectification, if any, as may be applicable".

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

In the instant case, term loan taken for the purpose of R&D equipment has been utilized for the purchase of car which has no relation with R&D equipment.

Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report as per Paragraph 3 clause ix of the CARO 2016, that out of the

term loan taken for R&D equipment, ₹ 15 lakh was not utilised for the purpose of acquiring R&D equipment.

Question 71

Physical verification of only 50% of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

Physical Verification of Inventory: Clause (ii) of Para 3 of CARO, 2016 requires the auditor to report on whether physical verification of inventory has been conducted at reasonable intervals by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification.

In the given case, the above requirement of CARO, 2016 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

Question 72

LM Ltd. had obtained a Term Loan of ₹ 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. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

Term Loan Invested in Short Term Deposits: As per clause (ix) of Para 3 of CARO, 2016, an auditor need to state in his report that whether the term loans were applied for the purpose for which the loans 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 clause (ix) of Para 3 of CARO, 2016.

Question 73

The long term borrowings from the parent has no agreed terms and neither the interest nor the principal has been repaid so far. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

As per clause (xiii) of para 3 of CARO 2016 the auditor is required to report, "whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as

required by the applicable accounting standards”.

In the present case, the auditor is required to report as per clause xiii of para 3 of CARO 2016 regarding receipt of long term borrowing from Parent Company which qualifies as a transaction with the related party.

Question 74

The Company is in the process of selling its office along with the freehold land available at Chandigarh and is actively on the lookout for potential buyers. Whilst the same was purchased at ₹ 25 Lakhs in 2008, the current market value is ₹ 250 Lakhs,

This property is pending to be registered in the name of the Company, due to certain procedural issues associated with the Registration though the Company is having a valid possession and has paid its purchase cost in full. The Company has disclosed this amount under Fixed Assets though no disclosure of non-registration is made in the notes forming part of the accounts. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

As per clause (i) (c) of para 3 of CARO 2016 the auditor is required to report, “whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof.”

In the present case, the Company has office along with freehold land in Chandigarh. Though company has paid its purchase cost in full however, this property is pending to be registered in the name of the company i.e. title deed is not in the name of Company since 2008. Therefore, the auditor is required to report the same in accordance with clause (i)(c) of para 3 of CARO 2016.

The reporting under this clause, where the title deeds of the immovable property are not held in the name of the Company, may be made incorporating following details, in the form of a table or otherwise in case of land:-

- total number of cases,
- whether leasehold / freehold,
- gross block and net block, (as at Balance Sheet date), and
- remarks, if any.

Question 75

An amount of ₹ 3.25 Lakhs per month is paid to M/s. WE CARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹ 0.25 Lakhs per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure has been made in the notes forming part of the accounts highlighting the same as a 'related party' transaction. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

As per clause (xiii) of para 3 of CARO 2016, the auditor is required to report, “whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies

Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;”

Therefore, the duty of the auditor, under this clause is to report (i) Whether all transactions with the related parties are in compliance with section 177 and 188 of the Companies Act, 2013 (“Act”); (ii) Whether related party disclosures as required by relevant Accounting Standards (AS 18, as may be applicable) are disclosed in the financial statements.

In the present case, the auditor is required to report as per clause xiii of para 3 of CARO 2016, as one of related party transaction amounting 3.25 lakhs per month i.e. in lieu of marketing services has been noticed of which amount ₹ 0.25 lakh per month is exceeding the arm’s length price has not been disclosed highlighting the same as related party transactions as per AS 18. Thus, the auditor is required to report accordingly.

Question 76

The Internal Auditor of the Company has identified a fraud in the recruitment of employees by the HR department wherein certain sums were alleged to have been taken as kick-back from the employees for taking them on board with the Company. After due investigation, the concerned HR Manager was sacked. The amount of such kickbacks is expected to be in the range of ₹12 Lakhs. Under CARO, 2016, as a statutory auditor, how would you report?

Answer

As per clause Clause (x) of para 3 of CARO 2016 the auditor is required to report, “whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.”

In the instant case, a fraud has been identified in recruitment of employees by the HR Department wherein certain sums were alleged to have been taken as kickback from the company of amounting rupees approx. 12 lakh. The auditor is required to report on the same in accordance with clause (x) of para 3 of CARO 2016.

Question 77

OK Ltd. has taken a term loan from a nationalized bank in 2015 for ₹ 200 lakhs repayable in five equal instalments of ₹ 40 lakhs from 31st March, 2016 onwards. It had repaid the loans due in 2016 & 2017, but defaulted in 2018, 2019 & 2020. As the auditor of OK Ltd. what is your responsibility assuming that company has sought reschedulement of loan?

Answer

Reporting for Default in Repayment of Dues: As per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to report whether the Company has defaulted in repayment of its dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

In this case, OK Ltd. has defaulted in repayment of dues for three years. Application for rescheduling will not change the default position. Hence the auditor has to report in his audit report that the Company has defaulted in its repayment of dues to the bank to the extent of ₹ 120 lakhs.

Question 78

X Ltd closed its manufacturing operations and sold all its manufacturing fixed assets during the financial year ended 31st March, 2020. However, it intends continue its operations as a trading company. In respect of other fixed assets, the company carried out a physical verification as at the end of 31st March, 2020 and found a material discrepancy to the tune of ₹ 1 lac, which was written off and is disclosed separately in the Statement of Profit and Loss. Kindly incorporate the above in your audit report.

Answer

Disclosure in Audit Report: As per SA 570 “Going Concern”, when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements-

- (i) Adequately describe the principal events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern and management’s plans to deal with these events or conditions; and
- (ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.

The auditor is further required to specifically include certain matters as per CARO, 2016 under section 143 of the Companies Act, 2013. According to clause (i)(b) of Para 3 of CARO, the auditor has to comment whether the fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

In the given case, X Ltd. has sold out its manufacturing fixed assets during the year. However, it intends to continue its operations as a trading company. Therefore, selling of manufacturing fixed assets does not affect the going concern assumption of the company. Additionally, while carrying out physical verification of fixed assets, a material discrepancy to the tune of ₹ 1 lac was found, which was written off and disclosed separately in the Statement of Profit and Loss. Hence, this fact needs to be disclosed in the Audit Report as follows:

Para in the Audit Report-

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

As per Accounting Standard (AS) 1, “Disclosure of Accounting Policies”, “the enterprise is normally viewed as a going concern that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.” Although the company has disposed off its manufacturing fixed assets during the financial year ending on 31-03-2020, it is still a going concern in the form of a trading company. We also report that on physical verification of other fixed assets, a material discrepancy to the tune of ₹ 1 Lac was noticed and that the same has been properly dealt with in the books of account.

Question 79

Big and Small Ltd. received a show cause notice from central excise department intending to levy a demand of ₹ 25 lakhs in December 2019. The company replied to the above notice in January 2020

contending that it is not liable for the levy. No further action was initiated by the central excise department upto the finalization of the audit for the year ended on 31st March, 2020. As the auditor of the company, what is your role in this?

Answer

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

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. Then the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. In case, if the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

Furthermore, the auditor's report under section 143 of the Companies Act, 2013 has to specifically include certain matters specified in Para 3 of CARO, 2016.

One of such matter is non-payment of dues to Government, on account of any dispute. As per clause (vii)(b) of Para 3 of CARO, 2016, in case dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

In the present case of Big and Small Ltd., issuance of show cause notice by Excise Department does not tantamount to demand payable by the Company. In so far as the Company has replied to the notice and no further correspondence was received from the Department. This show cause notice may be an alert or indication of non-compliance for the auditor. So auditor need to discuss with management and apply additional procedure. If the auditor concludes that there is non-compliance then provision for the same should be made as per AS 29. The auditor should also report the amount of dues not deposited on account of dispute and the forum where dispute is pending, in his audit report. If the management does not accept the request, the auditor should qualify the audit report accordingly or vice versa.

Question 80

C Limited has defaulted in repayments of dues to a financial institution during the financial year 2019-20 and the same remained outstanding as at March 31, 2020. However, the Company settled the total outstanding dues including interest in April, 2020 subsequent to the year end and before completion of the audit. Discuss how you would deal with this matter and draft a suitable Auditor's Report.

Answer

Reporting for Default in Repayment of Dues: As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, terms of repayment of term loans and other loans is required to be disclosed in the notes to accounts. It also requires specifying the period and amount of continuing default as on the balance sheet date in repayment of loans and interest, separately in each case.

Further, as per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to state in his report whether the Company has defaulted in repayment of dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

In the given case, C Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2019-20 which remain outstanding as at March 31, 2020. However, the company has settled the total outstanding dues including interest in April, 2020 but, the dues were outstanding as at March 31, 2020. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

“The company has taken a loan during the year, from a financial institution amounting to ₹ XXXX @ X% p.a. which is repayable by monthly installment of ₹ XXXX for XX months.

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2019-20 amounting to ₹ XXXX which remained outstanding as at March 31, 2020. The period of default is XXX days. However, the outstanding sum was settled by the company in April, 2020.”

Question 81

During the course of audit of CT Ltd. for the financial year 2019-20, it has noticed that ₹ 2.00 lakhs of employee contribution and ₹ 9.50 lakhs of employer contribution towards employee state insurance contribution have been accounted in the books of accounts in respective heads. Whereas, it was found that ₹ 4.00 lakhs only has been deposited with ESIC department during the year ended 31st March, 2020. The Finance Manager informed the auditor that due to financial crunch they have not deposited the amount due, but will deposit the amount overdue along with interest as and when financial position improves. Comment as a statutory auditor.

Answer

Non-Compliance of Laws and Regulations & Reporting Requirements: As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statement”, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity’s operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity’s financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, the auditor is required to report under clause (vii)(a) of Para 3 of CARO, 2016 whether the

company is regular in depositing undisputed statutory dues including employees' state insurance with the appropriate authorities 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.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of rupees 7.50 lakhs in his report.

Question 82

Paragraph 3(x) of CARO, 2016 requires the auditor to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. The clause does not require the auditor to discover such frauds.

The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. Comment.

Answer

Paragraph 3(x) of CARO, 2016 states that: Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated

This clause requires the auditor to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover such frauds. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds by the company or on the company by its Officer and employees that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Question 83

As per Paragraph 3(vi) of CARO, 2016, auditor is required to report whether maintenance of cost records has been specified by the Central Government under sub-section (1) of Section 148 of the Companies Act, 2013 and whether such accounts and records have been so made and maintained. Explain audit procedure and reporting in relation to this clause.

Answer

Audit Procedures and Reporting - Paragraph 3(vi) of CARO, 2016

- (i) The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word "made" applies in respect of cost accounts (or cost statements) and the word "maintained" applies in respect of cost records relating to materials, labour,

overheads, etc. The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the central government. The auditor should obtain a written representation from the management stating (a) whether cost records are required to be maintained for any product(s) or services of the company under section 148 of the Act, and the Companies (Cost Records and Audit) Rules, 2014; and (b) whether cost accounts and records are being made and maintained regularly. The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore, conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.

- (ii) It is necessary that the extent of the examination made by the auditor is clearly brought out in his report. The following wording is, therefore, suggested:
“We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 148 of the Act, and are of the opinion that prima facie, the prescribed accounts and records have been made and maintained.”
- (iii) Where the auditor finds that the records have not been written or are not prima facie complete, it will be necessary for the auditor to make a suitable comment in his report.

Question 84

C Limited has defaulted in repayments of dues to a financial institution during the financial year 2019-20 and the same remained outstanding as at March 31, 2020. However, the Company settled the total outstanding dues including interest in April, 2020 subsequent to the year end and before completion of the audit. Discuss how you would deal with this matter and draft a suitable Auditor's Report.

Answer

Reporting for Default in Repayment of Dues: As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, terms of repayment of term loans and other loans is required to be disclosed in the notes to accounts. It also requires specifying the period and amount of continuing default as on the balance sheet date in repayment of loans and interest, separately in each case.

Further, as per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to state in his report whether the Company has defaulted in repayment of dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

In the given case, C Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2019-20 which remain outstanding as at March 31, 2020. However, the company has settled the total outstanding dues including interest in April, 2020 but, the dues were outstanding as at March 31, 2020. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

“The company has taken a loan during the year, from a financial institution amounting to ₹ XXXX @ X% p.a. which is repayable by monthly installment of ₹ XXXX for XX months.

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2018-19 amounting to ₹ XXXX which remained outstanding as at March 31, 2020. The period of default is XXX days. However, the outstanding sum was settled by the company in

April, 2020.”

Question 85

In the case of companies carrying on the business of a non-banking financial institution, the auditor needs to report under CARO, 2016 whether the registration has been obtained under section 45-IA of the Reserve Bank of India Act, 1934, if required.

You are required to state in brief the audit procedure to be followed while reporting under above mentioned circumstances.

Answer

Reporting under CARO, 2016 for Registration under RBI Act, 1934: As per Clause (xvi) of paragraph 3 of the CARO, 2016, the auditor is required to report whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934. If so, whether the registration has been obtained.

Audit Procedures and Reporting-

- (i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.
- (ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

Question 86

What are the reporting requirements in the audit report under the Companies Act, 2013 / CARO, 2016 for the following situations?

- (i) A fraud has been committed against the company by an officer of the company.
- (ii) A fraud has been committed against the company by a vendor of the company.
- (iii) The company has committed a major fraud on its customer and the case is pending in the court.
- (iv) A fraud has been reported in the cost audit report but not noticed by statutory auditor in his audit.

Answer

Reporting Requirements in the Audit Report under the Companies Act, 2013 / CARO 2016:

According to Clause (x) of Para 3 of CARO 2016, the auditor is required to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the auditor is required to state the amount involved and the nature of fraud.

Further, **as per section 143(12) of the Companies Act, 2013**, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of

fraud is rupees 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than rupees 1 crore) within such time and in such manner as may be prescribed.

- (i) Fraud Committed against the Company by an Officer of the Company:** Fraud committed against the company by an officer of the company has to be reported in accordance with Clause (x) of Para 3 of CARO 2016, and as per section 143(12) of the Companies Act, 2013.
- (ii) Fraud committed against the company by a vendor of the Company:** In case employees or management are involved in fraud committed by vendor, reporting has to be done in accordance with CARO 2016 and as per section 143 (12) of the Companies Act, 2013. Suspected fraud by vendors, customers and other third parties should be dealt with in accordance with SA 240. Therefore, reporting has to be done in accordance with SA 240, "The Auditor's Responsibilities relating to Fraud in an audit of Financial Statements".
- (iii) Company has committed major fraud on its customer of which case is pending in the court:** Major fraud committed by the company on its customer has to be reported in accordance with Clause (x) of Para 3 of CARO 2016.
- (iv) Fraud reported in Cost Audit Report but not noticed by Statutory Auditor:** As per Clause (x) of Para 3 of CARO 2016, all frauds noticed or reported during the year shall be reported indicating the nature and amount involved as specified the fraud by the company or on the company by its officers or employees are only covered.

Here in the given scenario, a fraud has been reported in the cost audit report but not noticed by Statutory Auditor in his audit. Hence the statutory auditor has to report the nature and amount involved in the audit report as per section 143 of the Companies Act, 2013.

Chapter 6

Audit Reports

Question 1

Compare and explain the following:

- (i) Reporting to Shareholders vs. Reporting to those Charged with Governance
- (ii) Audit Qualification vs. Emphasis of Matter.

Answer

(i) Reporting to Shareholders vs. Reporting to those Charged with Governance:

REPORT	
Reporting to Shareholders	Reporting to those Charged with Governance
<ul style="list-style-type: none"> • Section 143 of the Companies Act, 2013 deals with the provisions relating to reporting to Shareholders. Thus, it is a Statutory Audit Report which is addressed to the members. 	<ul style="list-style-type: none"> • Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.
<ul style="list-style-type: none"> • Statutory Audit Report is on true and fair view and as per prescribed Format. 	<ul style="list-style-type: none"> • It is a reporting on matters those charged with governance like scope of audit, audit procedures, audit modifications, etc.
<ul style="list-style-type: none"> • Statutory Audit Reports are in public domain. 	<ul style="list-style-type: none"> • Reporting to those Charged with Governance is an internal document i.e. private report.

(ii) Audit Qualification vs. Emphasis of Matter:

REPORT	
Audit Qualification	Emphasis of Matter
<ul style="list-style-type: none"> • SA 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification. 	<ul style="list-style-type: none"> • SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deals with the provisions relating to Emphasis of Matter.
<ul style="list-style-type: none"> • Audit Qualifications are also known as "subject to report" or "except that report". 	<ul style="list-style-type: none"> • Emphasis of Matter is a paragraph which is included in auditor's report to draw users' attention to important matters which are already disclosed in Financial Statements & are fundamental to users for understanding of Financial Statements.

<ul style="list-style-type: none"> • Audit Qualifications are given when auditor is having reservations on some of the items out of financial statements as a whole i.e. Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements relating to if the impact of material misstatements is not pervasive on the financial statements but is present at some levels of the financial statements, qualified report is issued. 	<ul style="list-style-type: none"> • Emphasis of Matter is a paragraph which is issued when there is a uncertainty relating to future outcome of exceptional litigation, regulatory action, etc.; or there is early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
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Question 2

Relevant Notes given by the management in the financial statements of India Branch Office of ABC Limited are:

- Income tax authorities have raised demands (including interest upto the date of demand) aggregating to ₹ 100 crores and ₹ 40 crores respectively for assessment year 2014-15 based on report by auditors consequent to conduct of special audit as directed under section 142(2A) of the Income tax Act, 1961 and in addition, have also initiated penalty proceedings against the Company. The Company has contested these demands before the Commissioner of Income tax (Appeals) and has also filed applications for stay of penalty proceedings and the same are currently pending disposal.

Based on review of underlying documents and legal inputs, the management has assessed that there is probability of likely outflow to the extent of ₹ 50 crores (including interest liability till date of stay of payment of ₹ 15 crores) in relation to the above demands and has accounted for the same in these financial statements. With respect to further liability of ₹ 50 crores, the management believes that it has the necessary documents to furnish to the tax authorities and basis the expert's inputs believes that Company has good chances of success of receiving the judgments in its favour. Further, the management believes that the likelihood of penalties being imposed against the Company is not probable and accordingly, no adjustments are considered necessary in these financial statements.

- As at March 31, 2018, the Company has accumulated losses of ₹ 150 crores against equity of ₹ 100 crores and also net current liabilities of ₹ 35 crores. The management is of the view that the current year losses are primarily attributable to income tax liabilities devolving on the Company, as discussed under paragraph XX. As per the management assessment, it is likely to generate ₹_and ₹ from the operations during the financial years ending March 31, 2019 and March 31, 2020 respectively. Further, the Company's key shareholders have confirmed that they shall provide continuing financial support to the Company's day to day operations so as to enable the Company to pay off its debts, as and when they fall due. Accordingly, these financial statements have been prepared on a going concern basis.

As an auditor of ABC Limited, you are required to draft emphasis of matter para in the given situation on the basis of analysis of above notes (when there is material tax litigation that casts significant doubt on the entity being regarded as going concern)

Answer

Emphasis of Matters Para:

- We draw attention to Note XX, regarding certain income-tax demands of ₹ 100 crores pending in various stages of assessments/ appeals. The management based upon expert's advice believes that no demand or liability including interest and penalty on account of settlement of assessment/ appeals of the pending matters by the Income tax authorities is likely to devolve on the Company, in addition to those already provided for in these financial

statements. Pending the final outcome of the aforesaid matters, no further adjustments have been made in these financial statements in this regard.

- Note XX of the financial statements that as at March 31, 2018, the Company has accumulated losses of ₹ 150 crores against equity of ₹ 100 crores and also net current liabilities of ₹ 35 crores. These conditions indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern, which is dependent on establishing profitable operations and obtaining continuing financial support from its key shareholders. These mitigating factors have been more fully discussed in Note XX of the accompanying financial statements, in view of which the accompanying financial statements have been prepared under the going concern assumption, and consequently, no further adjustments have been made in these financial statements.

Our opinion is not modified in respect of the above matters.

Question 3

"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." As an expert you are required to brief the special considerations required for expressing:

- (a) Qualified Opinion;
- (b) Adverse Opinion and
- (c) Disclaimer of Opinion.

Answer

(a) Special consideration required for expressing Qualified Opinion: When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

- (i) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- (ii) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

(b) Special consideration needed for expressing Adverse Opinion: When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

- a. When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) [...] in accordance with [the applicable financial reporting framework]; or
- b. When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

(c) Special consideration is required for expressing Disclaimer of Opinion: When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- a. State that the auditor does not express an opinion on the accompanying financial statements;
- b. State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- c. Amend the statement required in SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with SA 701.

Question 4

ALM Associates has been appointed as auditor of M/s Hary Ltd. which acquired 55% shares-in M/s Sam Ltd. on 15th October, 2020. During audit of Harry Ltd., the auditors found that the company has not prepared consolidated financial statements because on the date of acquisition the fair value of certain assets & liabilities has not been ascertained which is significant and are accounted for on estimated basis only. Help ALM Associates in framing opinion paragraph of audit report.

Answer

Opinion Paragraph of Audit Report: In the instant case, M/s Hary Ltd. acquired 55% shares in M/s Sam Ltd. and the company did not prepare the consolidated financial statements because on the date of acquisition the fair value of certain assets and liabilities has not been ascertained. Therefore, accounting is done on estimate basis only which is not correct as the financial statements are materially misstated due to non-consolidation of subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. Thus, the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidences, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Adverse Opinion

In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2021, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

Basis for Adverse Opinion is given below:

As explained in Note X, the M/s Hary Ltd. has not consolidated subsidiary M/s Sam Ltd. that the M/s Hary Ltd acquired during 2020 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on an estimate basis. Under the accounting principles generally accepted in India, the Group should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had M/s Sam Ltd. been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects

on the consolidated financial statements of the failure to consolidate have not been determined.

Question 5

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- (i) Circumstances beyond the control of the entity;
- (ii) Circumstances relating to the nature or timing of the auditor's work; or
- (iii) Limitations imposed by management. Explain with the help of examples.

Answer

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- (i) Circumstances **beyond the control** of the entity;
- (ii) Circumstances relating to the **nature or timing of the auditor's work**; or
- (iii) **Limitations imposed by management**.

An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. Limitations imposed by management may have other implications for the audit, such as for the auditor's assessment of fraud risks and consideration of engagement continuance.

Examples of circumstances beyond the control of the entity include when:

- The entity's **accounting records** have been **destroyed**.
- The **accounting records** of a significant component have been **seized** indefinitely by governmental authorities.

Examples of circumstances relating to nature or timing of the auditor's work include when:

- The entity is **required to use the equity method of accounting** for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.
- The **timing of the auditor's appointment** is such that the auditor is **unable to observe the counting of the physical inventories**.
- The auditor determines that performing **substantive procedures alone is not sufficient**, but the entity's controls are not effective.

Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management **prevents** the auditor from observing the counting of the **physical inventory**.
- Management **prevents** the auditor from **requesting external confirmation** of specific account balances.

Question 6

Enumerate certain important matters which can be included in 'Emphasis of Matter paragraph'

in an auditor's report.

Answer

Emphasis of Matter Paragraph in Audit Reports: SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", deals with additional communication in the auditor's report when the auditor considers it necessary to draw user's attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to user's understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

Specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor's report in certain circumstances. These circumstances include:

- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- To alert users that the financial statements are prepared in accordance with a special purpose framework.
- When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

Question 7

Give examples of Emphasis of Matters which may have an adverse effect on the functioning of the company as well as those which may not affect the functioning of the company.

Answer

Examples of Emphasis of Matters which may have an Adverse Effect on the Functioning of the Company: Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- (i) An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- (ii) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- (iii) Early application (where permitted) of a new accounting standard that has a material effect

on the financial statements.

- (iv) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
- (v) The going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company's ability to continue as a going concern; or
- (vi) a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.

Examples of Emphasis of Matters which may not affect the Functioning of the Company are:

- (i) When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- (ii) To alert users that the financial statements are prepared in accordance with a special purpose framework.
- (iii) When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).
- (iv) on managerial remuneration which is subject to the approval of the Central Government;
- (v) relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;
- (vi) on frauds that have been dealt with in the financial statements of the company and would not have any accounting effect on the financial statements.

Question 8

Distinguish Self-interest threat from self-review threat in an Assurance Engagement.

Answer

Self Interest Threat and Self Review Threat in an Assurance Engagement

Self Interest Threat: Self-interest threats, which may occur as a result of the financial or other interests of a professional accountant or of a relative.

Circumstances that may create self-interest threats

- A financial interest in a client or jointly holding a financial interest with a client.
- Undue dependence on total fees from a client.
- Having a close business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- Contingent fees relating to an assurance engagement.

Self-Review Threat: Self-review threats, which may occur when a previous judgment needs to be re- evaluated by the professional accountant responsible for that judgment;

Examples of circumstances that may create self-review threats

1. The discovery of a **significant error during a re-evaluation** of the work of the professional accountant in public practice.
2. Reporting on the **operation of financial systems** after being involved in their design or implementation.
3. Having prepared the **original data** used to generate records that are the subject matter of the engagement.

4. A member of the **assurance team** being, or having recently been, a **director or officer** of that client.
5. A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.
6. Performing a service for a client that **directly affects** the subject matter of the assurance engagement.

Question 9

CA Sameer is the statutory auditor of Tram Fram Ltd. for the FY 2020 -21. While concluding the audit CA Sameer decided to issue an unmodified opinion, though he also concluded that a material uncertainty exists with respect to the company's ability to continue as a going concern on account of a pending litigation related to labour laws. He is of the view that the company has made appropriate disclosures with respect to such pending litigation in the notes to accounts annexed to the financial statements of Tram Fram Ltd. for the FY 2020-21. Explain how CA Sameer will deal with the above situation in his auditor's report (draft the relevant portion of the auditor's report.)

Answer

Material Uncertainty Related to Going Concern

We draw attention to Note 10 in the financial statements, which indicates that the outcome of a litigation on account of labour laws is pending in case of the company during the year 31 March, 2021. As stated in Note 11, this event or condition, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Question 10

XYZ Ltd. is a company engaged in the manufacture of cranes. CA Sudhir is the statutory auditor of the company for the FY 2020-21. The company has taken long term funding for fixed capital requirements and short term funding for its working capital requirements. During the course of audit, CA Sudhir found that the company's financing arrangements are about to expire and the company is unable to re- negotiate or obtain the replacement financing. As such the company may be unable to realize its assets and discharge its liabilities in the normal course of business. Notes to accounts annexed to the financial statements discuss the magnitude of financing arrangements, the expiration and the total financing arrangements; however the financial statements do not include discussion on the impact or the availability of refinancing. Thus, the financial statements (and notes thereto) do not fully disclose this fact. What kind of opinion should CA Sudhir issue in case of XYZ Ltd.?

Answer

In the present case, XYZ Ltd. is unable to re- negotiate or obtain the replacement financing for its long term and short term funding requirements. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore, XYZ Ltd. may be unable to realize its assets and discharge its liabilities in the normal course of business. Further, the financial statements of XYZ Ltd. do not disclose this fact adequately.

Thus, the financial statements of XYZ Ltd. are materially misstated due to the inadequate disclosure of the material uncertainty. CA Sudhir will express a qualified opinion as the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of XYZ Ltd. as at March 31, 2021, and profit/loss, for the year ended on that date.

Basis for Qualified Opinion

As discussed in Note 6, the Company's financing arrangements are about to expire and the Company has been unable to conclude renegotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this matter.

Question 11

ABC Ltd. is a company engaged in the manufacture of iron and steel bars. PP & Associates are the statutory auditors of ABC Ltd. for the FY 2020-21. During the course of audit, CA Prakash, the engagement partner, found that the Company's financing arrangements have expired and the amount outstanding was payable on March 31, 2021. The Company has been unable to renegotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. What opinion should CA Prakash express in case of ABC Ltd.?

Answer

In the present case based on the audit evidence obtained, CA Prakash has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements of ABC Ltd. omit the required disclosures relating to the material uncertainty.

In such circumstances, CA Prakash should express an adverse opinion because the effects on the financial statements of such omission are material and pervasive.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of the entity as at March 31, 2021, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute

of Chartered Accountants of India.

Basis for Adverse Opinion

The financing arrangements of ABC Ltd. has expired and the amount outstanding was payable on March 31, 2021. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

Question 12

MNO Ltd. is a power generating company having its plants in the north eastern states of the country. For the FY 2020-21, M/s PRT & Associates are the statutory auditors of the company. During the course of audit, the audit team was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment (in XYZ Ltd.) that represents over 90% of the entity's net assets. What kind of opinion should the statutory auditors issue in such case?

Answer

M/s PRT & Associates are unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are both material and pervasive to the consolidated financial statements.

Therefore, the statutory auditor should issue a disclaimer of opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of MNO Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at ₹ 95 crores on the Group's consolidated balance sheet, which represents over 90% of the Group's net assets as at March 31, 2021. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, (and the elements making up the consolidated statement of changes in equity) and the consolidated cash flow statement.

Question 13

CA Yash is the statutory auditor of Laksmi Vardhan Limited for the FY 2020-21. In respect of loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash and in absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

What kind of opinion should CA Yash give in such situation?

Answer

In the present case, with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash. In absence of such agreement, CA Yash is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidences is the loan agreement. Therefore, the absence of such document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA Yash to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA Yash should give a qualified opinion

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of Laksmi Vardhan Limited give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on 31.03.2021 and profit/ loss for the year ended on that date.

Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ₹55,00,000/- given to Sarvagya Private Limited. Consequently, in absence of such agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

Question 14

In the financial year 2020-21, MSD Ltd. faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. These circumstances indicate material uncertainty on the company's ability to continue as going concern. Due to such event it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. The financial statement and notes to the financial statements of the company do not disclose this fact. What kind of opinion should the statutory auditor of MSD Ltd. issue in such circumstances?

Answer

In the present case, there exists a material uncertainty that cast a significant doubt on the company's ability to continue as going concern and the same is not disclosed in the financial statements of MSD Ltd.

As such, the financial statements of MSD Ltd. for the FY 2020 -21 are materially misstated and the effect of the misstatement is so material and pervasive on the financial statements that giving

only a qualified opinion will be insufficient and therefore the statutory auditor of MSD Ltd. should issue an adverse opinion.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of MSD Ltd. as at March 31, 2021, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

MSD Ltd. has faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. Due to such event it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statement and notes to the financial statements of the company do not disclose this fact.

Question 15

CA Abhimanyu is the statutory auditor of PQR Ltd. for the FY 2020-21. During the course of audit CA Abhimanyu noticed the following:

1. With respect to the debtors amounting to ₹ 150 crores, no balance confirmation was received by the audit team. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹25 Cr. during the year under audit. The Company has stated that the provision is based on receivables which are older than 36 months, which according to the audit team is inadequate and as such the audit team is unable to ascertain the carrying value of trade receivables.
2. Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. The audit team was unable to undertake the physical inventory count as such the value of inventory could not be verified.

Under the above circumstances what kind of opinion should CA Abhimanyu give?

Answer

In the present case, CA Abhimanyu is unable to obtain sufficient and appropriate audit evidence with respect to the following:

1. The balance confirmation with respect to debtors amounting to ₹ 150 crores is not available. Further there has been default in payment by the debtors and the provision so made is not adequate. The audit team is also unable ascertain the carrying value of trade receivables.
2. With respect to 40% of the company's inventory, neither the physical verification has been done by the management nor are adequate inventory records maintained. The audit team is also unable to undertake the physical inventory count as such the value of inventory could

not be verified.

In the above two circumstances the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Thus, CA Abhimanyu should give a Disclaimer of Opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of PQR Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We are unable to obtain balance confirmation with respect to the debtors amounting to ₹ 150 crores. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹25 Cr. during the year under audit which is inadequate in the circumstances of the company. The carrying value of trade receivables could not be ascertained.

Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. We were unable to undertake the physical inventory count and as such the value of inventory could not be verified.

Question 16

In respect of the audit of BDS Ltd., the statutory auditor of the company noticed some matters. The statutory auditor wants to draw the user's attention towards such matters, though his opinion is not modified in respect of such matters. Draft the relevant paragraphs of the audit report for the following matters:

- i. The company has a plan to resume its construction activities with respect to one of its thermal power project, The activity of such power plant was suspended in the FY 2018-19. The thermal power project comprises of the plant and equipment amounting to ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.
- ii. The financial statements of 5 branches are included in the Standalone Financial Statements of BDS Ltd. whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2021 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors.

Answer

Emphasis of Matter

We draw attention to the following note of the standalone financial statements:

Note 27 regarding the plans of the Company to resume construction/developmental activities of a thermal power project. The carrying amounts related to the project as at 31st March, 2021 comprise of plant and equipment of ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.

Our opinion is not modified in respect of this matter.

Other Matter

We did not audit the financial statements of 5 branches included in the Standalone Financial Statements of the company whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2021 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of the branch auditors.

Our opinion is not modified in respect of this matter.

Question 17

Write a short note on Certificate for Special Purpose vs. Audit Report.

Answer

Certificate for Special Purpose vs. Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and **does not involve any estimate or opinion**. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account. A **report**, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the **application of due care and skill**. The 'report' involves expression of opinion which may differ from one professional to another. There is **no question of exactitude in case of a report** since the information contained therein is based on estimates and involves judgement element.

Question 18

KPI Ltd is a joint venture of KPI Inc, a company based in US, and OPQ Ltd, a company based in Japan (hereinafter referred to as 'JV partners'). KPI Ltd was registered in India and is operating as a marketing support company for KPI Inc. All the costs of KPI Ltd are incurred in India and entire revenue of KPI Inc is generated in USD. The entire funding requirements of KPI Ltd are taken care of by the JV partners. Since KPI Ltd is based in India, hence it is also required to get its financial statements audited.

The company appointed new auditors for the audit of the financial statements for the year ended 31 March 2021 after doing all appointment formalities wherein auditors are required to ensure compliance with Standards on Auditing and Internal Standards on Auditing.

As an expert you are required to advise the auditor about the requirements regarding auditor's report for audits conducted in accordance with both Standards on Auditing issued by ICAI and International Standards on Auditing.

Answer

An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

- (a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:
 - (i) to form a different opinion, or
 - (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and
- (b) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

Question 19

AKB Associates, a renowned audit firm in the field of CA practice for past two decades. The firm was appointed to conduct statutory audit of Rica Ltd. an unlisted company, which is engaged in the business of paper manufacturing. It decided to commence the audit for the recently concluded financial year. Once after making significant progress in the audit, the auditors made the following observations:

Observation 1: The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material.

Observation 2: Due to flood, few records maintained by the Company with respect to a particular transaction was completely destroyed and there was no duplicate record maintained by the Company. However, those details were not pervasive, but material.

You are required to advise, whether AKB Associates should report Observation 1 and 2 in its audit report? If so, under which heading should it be reported?

Answer

Observation 1 - The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material: As per SA 706, "Emphasis of Matter Paragraph & Other Matter Paragraph in the Independent Auditor's Report", an Emphasis of Matter Paragraph refers to matter appropriately disclosed in the financials, that in the auditor's judgement is of such importance that it is fundamental to users' understanding of the financials. Hence, in this case, the auditor shall report about the consequences of the flood which affected the Company's warehouse under Emphasis of Matter Paragraph.

Observation 2 - Due to flood, few records maintained by the Company with respect to a particular transaction was completely destroyed and there was no duplicate record maintained by the Company. However, those details were not pervasive, but material: As per SA 705, “Modification to Opinion in the Independent Auditor’s Report”, where the auditor is unable to obtain sufficient and appropriate audit evidence and where such matter is material but not pervasive, the auditor shall issue a qualified opinion.

Thus, in the given situation, on account of flood few records pertaining to particular transactions was completely destroyed and in the absence of duplicate records, the auditor was unable to obtain sufficient and appropriate audit evidence and those details were material but not pervasive. Therefore, in accordance with SA 705, the auditor is required to issue qualified opinion.

Chapter - 7

Audit Committee and Corporate Governance

Question 1

State the key features of the Qualified and Independent Audit Committee set up under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

Answer

The main features of a qualified and independent audit committee to be set up under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 are as follows:

1. The audit committee shall have **minimum three directors** as members. **Two-thirds** of the members of audit committee shall be **independent directors, however, in case of a listed entity having outstanding SR (Superior Rights) equity shares, the audit committee shall only comprise of independent directors;**
2. **All** members of audit committee shall be **financially literate** and at least **one member** shall have accounting or related **financial management expertise;**

Explanation (i): The term “financially literate” means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation (ii): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

3. The **Chairperson** of the Audit Committee shall be an **independent director;**
4. The Chairperson of the Audit Committee shall be **present at Annual General Meeting** to answer shareholder queries;
5. The **Audit Committee at its discretion shall invite the finance director** or the head of the finance function, head of internal audit and a representative of the statutory auditor and any other such executives to be present at the meetings of the committee; provided that occasionally, the Audit Committee may meet without the presence of any executives of the listed entity.;
6. **The Company Secretary shall act as the secretary to the committee.**

Question 2

Comment on the following in the light of certificate of compliance of conditions of Corporate Governance to be issued for a listed company where the Board consists of 10 directors including a non-executive director as its chairman:

- (i) There were 5 audit committee meetings held during the year as follows 01/04/2018, 01/06/2018, 01/09/2018, 03/01/2019, 25/03/2019.
- (ii) There are 4 independent directors. One of them resigned on 25/05/2018. A new independent director was appointed on 01/09/2018.
- (iii) The Chairman of Audit Committee did not attend the Annual General Meeting held on 14/09/2018.

- (iv) There is no woman director.

Answer

Compliance of conditions of Corporate Governance in case of Listed Company: As per Listing Obligation and Disclosure Requirements Regulations 2015, depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of corporate governance for example:

- (i) The Audit Committee shall **meet at least four times in a year and not more than one hundred and twenty days shall lapse between two meetings**. The number of days between the meetings held on 1.9.2018 and 3.01.2019 is more than 120 days. Hence it is a non-compliance and would require qualification in certificate of corporate governance
- (ii) Since the Chairman is the non-executive director, there should be **1/3rd of directors (rounded to next integer) to be independent**. In this case, 4 directors need to be independent. Any vacancy during shortfall of independent directorship should be filled within next 3 months or before the start of next meeting, whichever is later. In the instant case, since the independent director was appointed after lapse of 3 months (i.e. on 1.9.2018) and after next first meeting 1/6/2018, there is default which would require qualification in certificate on corporate governance.
- (iii) Chairman shall be **present at Annual General Meeting** to answer shareholder queries. In the given scenario, Chairman of Audit Committee did not attend the Annual General Meeting held on 14/09/2018 which is not in order/compliance.
- (iv) The auditor should ascertain whether, throughout the reporting period, the Board of Directors **comprises an optimum combination of executive and non-executive directors, with at least one-woman director**. Therefore, there should be at least one-woman director. In the given situation, there is no woman director which is again not in compliance.

Question 3

M/s All-in-One Limited is a large-sized listed Indian Company with focus on design and delivery of custom made Information Technology applications for various business entities in India and abroad. The Management wants to know whether they are required to constitute Risk Management Committee as per LODR, 2015 and if so, required, what should be its composition? Advise.

Answer

Constitution of Risk Management Committee: As per regulation 21 of LODR 2015, provision relating to constitution of risk management committee is **applicable to top 500 listed entities**, determined on the basis of market capitalisation, as at the end of the immediate previous financial year. In the instant case, All-in-One Limited, is a large sized listed Indian Company with focus on design and delivery of custom made IT applications for various business entities in India and abroad. As per fact of the case it is a large sized listed Indian company, assuming that it is

included in top 500 listed entities, All - in - One Limited is required to constitute risk management committee.

Composition of Risk Management Committee:

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- (i) The **Board of Directors** shall **constitute** a Risk Management Committee.
- (ii) The **majority of members** of Risk Management Committee shall consist of members of the **Board of Directors**.
- (iii) The **Chairperson** of the Risk Management Committee shall be a **member of the Board of Directors** and senior executives of the listed entity may be members of the committee.
- (iv) The Board of Directors shall **define the role and responsibility** of the Risk Management Committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit.

These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. A majority of this Committee will be the members of the Board of Directors. Senior executives of the company may also be members of the Committee, but the Chairperson of the Committee shall be a member of the Board of Directors.

Question 4

You have been appointed as an auditor of M/s Real Ltd. in which total number of directors in the board is 9. As an auditor, state the points to be considered in verification of composition of Board under Regulation 17 of The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015.

Answer

Verification regarding Composition of Board [Regulation 17]

- (i) The auditor should ascertain whether, throughout the reporting period, the Board of Directors **comprises an optimum combination of executive and non-executive directors, with at least one woman director and not less than 50% of the Board of Directors comprising non-executive directors**. The minutes of the Board of Directors' meetings should be verified to ascertain whether a director is an executive director or a non-executive director.
- (ii) The auditor should also verify that where **the Chairperson of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors** and in case the listed entity does not have a regular non-executive Chairperson, at least half of the Board of Directors should comprise independent directors. Further, **if the regular non-executive Chairperson is a promoter** of the listed entity or is related to any promoter or person occupying management positions at the Board level or at one level below the Board, **at least one-half** of the Board of the listed entity shall consist of **independent directors**.

In determining the number of requisite independent directors and/or non-executive directors, the **fraction**, if any, in the number of one-half or one-third as the case may be, should be **rounded off**. Since the terms in this clause refer to 'not less than' and 'at least', it would be appropriate to compute the number by rounding off any fraction to the next integer. For example, in a Board headed by a non-executive Chairman and comprising of six other directors (i.e., seven directors), the independent directors should be three or more.

- (iii) **Annual disclosure** submitted by the directors to the Board of Directors may be **examined** for this purpose. If the Board of Directors has followed any particular procedure(s) to ascertain the independence of directors, the auditor should examine the same. Effect of changes in the composition of the Board and/or its Chairman and its impact on compliance

throughout the reporting period should also be examined.

- (iv) An **independent non-executive director**, apart from receiving remuneration, should **not have any material pecuniary relationship with the listed entity**, its holding, subsidiary or associate company, or their promoters, or directors, **during the two immediately preceding financial years or during the current financial year**. Also, such independent director, either by himself or with any of his relatives should not be a material supplier, service provider or customer or a lessor or lessee of the listed entity and should not also be a substantial shareholder of the listed entity. In determining 'not a substantial shareholder', he (together with his relatives) should not own 2% or more of total voting power of the listed entity.

Question 5

List few documents that require mandatory review by Audit Committee.

Answer

The Audit Committee shall mandatorily review the following information as per LODR Regulations:

- (i) Management **discussion and analysis of financial condition and results of operations;**
- (ii) Statement of **significant related party transactions** (as defined by the Audit Committee), submitted by management;
- (iii) Management letters / **letters of internal control weaknesses** issued by the statutory auditors;
- (iv) **Internal audit reports** relating to internal control weaknesses;
- (v) The **appointment, removal and terms of remuneration of the Chief internal auditor** shall be subject to review by the Audit Committee; and
- (vi) **Statement of deviations:** (a) **quarterly statement** of deviations including report of monitoring agency if applicable and (b) **annual statement** of funds utilized for purposes other than those stated in the offer document/ prospectus/ notice.

Question 6

D Ltd., a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India, the revenue of the company is going down and there is slowdown in other activities of the company. Therefore, it is expected that there would not be significant work for members of the Audit Committee.

Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet only once at the year end. They reviewed monthly information system of the Company and found no errors,

As an auditor of D Limited, would you consider the decision taken by the Audit Committee to hold the meeting once in a year, in complying with Listing Obligation and Disclosure Requirements (LODR)? Also state the quorum requirements for such meetings.

Answer

One of the following additional requirement as stipulated under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR Regulations") on which Section

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177 of the Companies Act, 2013 (relating to audit committee) is silent is: The Audit Committee should meet at least four times in a year and not more than one hundred and twenty days shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent directors present.

The Audit Committee shall mandatorily review the following information as per LODR Regulations:

- (i) Management **discussion and analysis of financial condition and results of operations;**
- (ii) Statement of **significant related party transactions** (as defined by the Audit Committee), submitted by management;
- (iii) **Management letters** / letters of internal control weaknesses issued by the statutory auditors;
- (iv) **Internal audit reports** relating to internal control weaknesses;
- (v) The **appointment, removal and terms of remuneration of the Chief internal auditor** shall be subject to review by the Audit Committee; and
- (vi) **Statement of deviations:** (a) quarterly statement of deviations including report of monitoring agency if applicable and (b) annual statement of funds utilized for purposes other than those stated in the offer document/ prospectus/ notice.

In the instant case, due to recessionary conditions, slowdown in activities of the company and not expecting the significant work for the members of the audit committee, D Ltd. decided unanimously to meet only once at the year end. They also reviewed monthly information system of the company and found no errors.

In view of above, **decision taken by the audit committee to hold the meeting only once at the year end is not correct** as the Audit Committee should meet at least four times in a year and not more than one hundred and twenty days shall elapse between two meetings.

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

Question 7

Write short notes on the following:

- (a) Content of Management Discussion and Analysis.
- (b) Corporate Governance

Answer

- (a) **Content of Management Discussion and Analysis:** As part of the directors' report or as an addition thereto, a **Management Discussion and Analysis report should form part of the Annual Report to the shareholders.** This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position-
 - (i) **Industry structure and developments.**
 - (ii) **Opportunities and Threats.**
 - (iii) **Segment-wise or product-wise performance.**
 - (iv) **Outlook.**
 - (v) **Risks and concerns.**

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- (vi) **Internal control systems and their adequacy.**
 - (vii) **Discussion on financial performance** with respect to operational performance.
 - (viii) **Material developments in Human Resources/Industrial Relations** front, including number of people employed.
 - (ix) **Details of significant changes** (i.e. change of 25% or more as compared to the immediately previous financial year) **in key financial ratios**, along with detailed explanations therefor, including:
 - (1) Debtors Turnover
 - (2) Inventory Turnover
 - (3) Interest Coverage Ratio
 - (4) Current Ratio
 - (5) Debt Equity Ratio
 - (6) Operating Profit Margin (%)
 - (7) Net Profit Margin (%)or sector-specific equivalent ratios, as applicable.
 - (x) Details of any **change in Return on Net Worth** as compared to the immediately previous financial year along with a detailed explanation thereof.
- (b) **Corporate Governance:** Corporate governance is the system by which **companies are directed and controlled by the management in the best interest of the shareholders** and others ensuring greater transparency and better and timely financial reporting. The **Board of Directors are responsible for governance of their companies**. A number of reports and codes of corporate governance have been published internationally.
- SEBI on September 2, 2015, issued the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“LODR Regulations”), with the **objective of streamlining and consolidating the provisions of various listing agreements** in operation for different segments of the capital markets, such as equity shares, preference shares, debt instruments, units of mutual funds, Indian depository receipts, securitised debt instruments and any other securities that the SEBI may specify.
- The **LODR Regulations are divided into two parts** - the **substantive provisions** are **incorporated in the main body** while the **procedural requirements** are incorporated in the **form of schedules**. The LODR Regulations also capture the corporate governance principles found in Clause 49 of SEBI’s Model Listing Agreement. It may be noted that the **LODR Regulations deal with only post-listing requirements and exclude all pre- listing requirements**.

Question 8

Write a short note on Issues addressed in the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 regarding Corporate Governance.

Answer

Issues of Corporate Governance: **Issues addressed in the SEBI** (Listing Obligations and Disclosure Requirements) **Regulations, 2015 regarding corporate governance are-**

- (i) **Responsibilities and key functions of the Board**, its composition, compensation and disclosures;
- (ii) **Code of Conduct and vigil mechanism;**

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- (iii) Composition, meetings, powers, role and responsibilities of the **Audit Committee** which is an important pillar of corporate governance;
- (iv) **Management of subsidiary companies;**
- (v) Procedures related to **risk management;**
- (vi) Disclosures on important issues regarding **related party transactions**, accounting treatment, etc.;
- (vii) Content of **management discussion and analysis;**
- (viii) Information to shareholders;
- (ix) **Compliance Certificate** by the CEO and CFO;
- (x) **Compliance Certificate from** either the **auditors** or practising company secretaries regarding compliance of conditions on corporate governance.

Question 9

XYZ Limited has conducted 4 meetings in 2019-20. i.e. June 15, 2019, October 18, 2019, February 10, 2020 and June 10, 2020. Does it comply with provisions of conducting meeting?

Answer

As per Listing Obligation and Disclosure Requirements Regulations 2015, depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of corporate governance. **The Audit Committee shall meet at least four times in a year and not more than one hundred and twenty days shall lapse between two meetings.**

In the given case, XYZ Limited has conducted 4 meetings in 2019-20. i.e. June 15, 2019, October 18, 2019, February 10, 2020 and June 10, 2020. **It does not comply with provisions because time gap between June 15 and October 18 is more than 120 days i.e. 125 days.**

Question 10

Statutory auditor of ABC Limited has resigned on July 10, 2020. Whether he shall be liable for issuing limited review report for quarter ended June 30, 2020.

Answer

All listed entities/material subsidiaries while appointing/re-appointing an auditor shall ensure compliance with **If the auditor resigns within 45 days from the end of a quarter** of a financial year, then the **auditor shall, before such resignation, issue the limited review/ audit report for such quarter.**

In the given situation, statutory auditor of ABC Limited has resigned on July 10, 2020. **he would be liable for issuing limited review report for quarter** ended June 30, 2020 because time gap between July 13, 2020 and June 30, 2020 is less than 45 days.

Question 11

Audit Committee and Corporate Governance

PQR, auditor of XYZ Limited has signed limited review report of 2nd and 3rd quarter. Whether auditor is liable to issue limited review report of 4th quarter before resignation?

Answer

All listed entities/material subsidiaries while appointing/re-appointing an auditor shall ensure compliance **in case the auditor has signed the limited review/ audit report for the first three quarters** of a financial year, then the **auditor shall, before such resignation, issue the limited review/ audit report for the last quarter of such financial year as well as the audit report for such financial year.**

In the instant case, PQR, auditor of XYZ Limited has signed limited review report of 2nd and 3rd quarter. **Auditor is not liable to issue limited review report of 4th quarter** because he has not signed limited review report of first 3 quarters.

Question 12

The Board of Directors of PQR Ltd. have laid down the code of conduct for all Board members and senior management. The auditor is provided with the annual compliance affirmations received from the Board members and explained that since there has been no change in the composition of the senior management, the previous year's affirmations may be considered valid. Is the contention of the Company valid?

Answer

Under Regulation 26(3) of LODR, all Board members and senior management personnel have to **affirm compliance with the code on an annual basis.** The decision to consider the previous year's affirmations from the senior management personnel as valid is **not in line** with the LODR Regulations.

Question 13

RST Ltd. has established a vigil mechanism to enable its directors and employees to report genuine concerns and seek protection against victimization. The details of the mechanism are available on the company intranet which is accessible by the directors and employees. Are the measures taken by the Company in line with the LODR Regulations?

Answer

Under Regulation 22 of the LODR, the **vigil mechanism can be used by directors, employees and any other person.** To that effect, Regulation 46 of the LODR requires the details of establishment of such mechanism to be **disclosed by the Company on its website and in the Board Report.** By only providing the details in the intranet, the Company has failed to meet the LODR Regulations.

Question 14

Genuine Ltd. has established the Internal Complaints Committee under the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013 ('POSH Act'). The details (names, email addresses and contact numbers) of the Committee members are available on the

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company intranet which is accessible by all employees. However, no disclosure regarding number of complaints pertaining to sexual harassment of women at workplace is being made. Are the measures taken by the Company adequate?

Answer

As per Schedule V Disclosures in relation to the Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013, amongst other matters, **following should be disclosed in the section on Corporate Governance of the Annual Report:**

- number of **complaints filed** during the financial year
- number of **complaints disposed** of during the financial year
- number of **complaints pending** as on end of the financial year.

The **POSH Act offers protection to all women**, be it employees or contract staff or any other women who are associated with the Company in any other capacity (including service providers, vendors, professionals, etc.) By only providing the details in the intranet, **the Company has failed to meet the requirements under the POSH Act**. In view of above, Genuine Ltd. is required to make necessary disclosures in accordance with Schedule V of SEBI (LODR) Regulation 2015.

Question 15

M/s FCA & Associates, Chartered Accountants is one of the leading auditing firms in Guwahati. The firm received an assignment to examine the compliance conditions [as stated in SEBI (LODR) Regulations] of corporate governance by ABC Ltd., a listed entity with no outstanding SR equity shares. The firm had made the following observations:

Observation No. 1: Mr. Fine, one of the Director of the Company, also the Chairman of the Stakeholder Relationship Committee, was acting as the audit committee Chairman in 4 other listed companies as well & 1 private company, simultaneously.

Observation No. 2: The Nomination & Remuneration Committee consisted of 6 members, which regularly met biannually.

Observation No. 3: The Risk Management Committee consisted of 9 directors, out of which, the number of independent directors is the majority, but it was less than two thirds of the total strength.

Which among the above three observations made by the auditor of ABC Ltd. should be reported by M/s. FCA & Associates?

Answer

Observation No. 1 - Mr. Fine, one of the Director of the Company, also the Chairman of the Stakeholder Relationship Committee, was acting as the Audit committee Chairman as well in 4 other listed companies & 1 private Company, simultaneously: As per Regulation 26 of SEBI (LODR) Regulations, a Director cannot be a Chairman in more than 5 committees across all listed entities. However, for the purpose of reckoning the limit under this Regulation, chairmanship of committees in a private company shall be excluded. In this case, since Mr. Fine is the Chairman of audit committee in ABC Ltd. and Chairman in 4 other listed companies, there is no violation of the limit specified under the Regulation 26. Accordingly, **this observation need**

not be reported by the auditor.

Observation No. 2: The Nomination & Remuneration Committee consisted of 6 members, who regularly met biannually: As per Regulation 19, Part D of Schedule II of SEBI (LODR) Regulations, every listed company should have a Nomination & Remuneration Committee, which shall meet at least once in a year. **Since, in the given case the committee met biannually (i.e. once in 2 years), the said observation needs to be reported by the auditor.**

Observation No. 3: The Risk Management committee consisted of 9 directors, out of which the number of independent directors is the majority, but it was less than two thirds of the total strength: As per Regulation 21 of SEBI (LODR) Regulations, only in case of a listed entity having outstanding SR equity shares, at least two thirds of Risk Management Committee shall comprise of independent directors. In the given case, ABC Ltd. does not have outstanding SR equity shares. **Accordingly, this observation need not be reported by the auditor.**

Thus, in the given scenario, only observation 2 will be reported.

Question 16

What is the minimum information required to be placed before board of directors as per LODR Regulation 17(7).

Answer

Minimum information required to be placed before board of directors:

- A. Annual **operating plans and budgets** and any updates.
- B. **Capital budgets** and any updates.
- C. **Quarterly results** for the listed entity and its operating divisions or business segments.
- D. **Minutes of meetings** of audit committee and other committees of the board of directors.
- E. The **information on recruitment and remuneration of senior officers** just below the level of board of directors, including appointment or removal of Chief Financial Officer and the Company Secretary.
- F. **Show cause, demand**, prosecution notices and penalty notices, which are materially important.
- G. **Fatal or serious accidents**, dangerous occurrences, any material effluent or pollution problems.
- H. Any **material default in financial obligations** to and by the listed entity, or substantial non- payment for goods sold by the listed entity.
- I. Any issue, which involves possible **public or product liability claims** of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the listed entity or taken an adverse view regarding another enterprise that may have negative implications on the listed entity.
- J. Details of **any joint venture or collaboration agreement**.

Question 17

What is Whistle Blower Policy (Vigil Mechanism) as per SEBI LODR regulations?

Answer

Whistle Blower Policy as per SEBI LODR regulations -

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- (i) The company shall establish a **vigil mechanism for directors and employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy.**
- (ii) This mechanism should also provide **for adequate safeguards against victimization of director(s) / employee(s) who avail of the mechanism and** also provide for direct access to the Chairman of the Audit Committee in exceptional cases.
- (iii) The **details** of establishment of such mechanism shall be **disclosed by the company on its website and in the Board's report.**

Question 18

The Directors and senior management of a listed company of which you are the statutory auditor, want to know their obligations under the SEBI Regulations in regard to Board or Non-Executive Directors.

Answer

Obligations of Director and Senior Management:

- (i) The **Board shall meet at least four times a year, with a maximum time gap of one hundred and twenty days between any two meetings.** The **quorum** for every meeting of the board of directors of the **top 2,000 listed entities shall be one-third of its total strength** or three directors, whichever is higher, including at least one independent director.
- (ii) A **director shall not be a member in more than ten committees or act as Chairperson of more than five committees** across all listed entities in which he is a director. Furthermore, every director shall inform the listed entity about the committee positions he occupies in other listed entities and notify changes as and when they take place.

It may be noted that for the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 8 of the Companies Act, 2013 shall be excluded and for the purpose of reckoning the limit under this sub-clause, Chairpersonship/membership of the Audit Committee and the Stakeholders' Relationship Committee alone shall be considered.
- (iii) The **Board shall periodically review compliance reports of all laws applicable** to the listed entity, prepared by the listed entity as well as steps taken by the listed entity to rectify instances of non-compliances.
- (iv) **Non-executive directors shall be required to disclose their shareholding** (both own or held by / for other persons on a beneficial basis) in the listed entity in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.
- (v) An **independent director shall be held liable**, only in respect of such acts of omission or commission by the listed entity **which had occurred with his knowledge**, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the LODR Regulations.
- (vi) The **independent directors of the listed entity shall hold at least one meeting in a year,**

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without the presence of non-independent directors and members of the management and all the independent directors shall strive to be present at such meeting.

- (vii) **Senior management shall make disclosures to the board relating to all material financial and commercial transactions**, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)
- (viii) An **independent director** who resigns or is removed from the Board of Directors of the listed entity shall be **replaced by a new independent director at the earliest but not later than the immediate next Board meeting or three months from the date of such vacancy, whichever is later.**

It may be noted that where the listed entity fulfils the requirement of independent directors in its Board even without filling the vacancy created by such resignation or removal, as the case may be, the requirement of replacement by a new independent director shall not apply.

- (ix) The **Board of Directors of the listed entity shall satisfy itself that plans are in place** for orderly succession for appointments to the Board and to senior management.

Question 19

A listed entity has to obtain a compliance certificate from either the statutory auditors or practicing company secretaries regarding compliance of conditions of corporate governance and annex it to the Directors' Report. Discuss some situations which may require an adverse or qualified statement in respect of the above certificate.

Or

Discuss adverse or qualified statement or disclosure, which you would like to make in respect of non-compliance with requirements of Corporate Governance of a company.

Answer

Adverse or Qualified Statement: Depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of corporate governance.

Examples of such circumstances:

- (i) The **number of non-executive directors is less than 50%** of the strength of Board of directors.
- (ii) A qualified and independent **audit committee is not set up.**
- (iii) The **Chairman** of the audit committee is **not an independent director.**
- (iv) The **Audit Committee does not meet four times a year.**
- (v) The **necessary powers** in terms of Part C of Schedule II have **not been vested by the Board** in the Audit Committee.
- (vi) The **time gap between two Board meetings is more than one hundred and twenty days.**
- (vii) A **director is a member of more than ten committees or acts as Chairman of more than five committees** across all companies in which he is a director.

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- (viii) The **information of quarterly results is neither put on the listed entity's website** nor sent in a form so as to enable the stock exchange on which the entity's securities are listed to enable such stock exchange to put it on its own website.
- (ix) The **power of share transfer is not delegated to an officer** or a committee or to the registrar and share transfer agents.

Question 20

BG Limited is a large-sized listed company. The Board of directors have constituted Nomination and Remuneration committee comprising of non-executive and independent directors. The management seeks your advice on the composition and role of the committee. Elucidate the composition and role of Nomination and Remuneration committee as per SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

Answer

Composition and role of Nomination and Remuneration committee:

The Board of Directors of every listed public company shall constitute the Nomination and Remuneration Committee which shall **comprise of at least three directors, all of whom shall be non-executive directors and at least half shall be independent directors**. However, in case of a listed entity having outstanding SR equity shares, two thirds of the committee shall comprise of independent directors. **Chairperson of the committee shall be an independent director**.

It may be noted that the **Chairperson of the listed entity** of the company (whether executive or nonexecutive) **may be appointed as a member** of the Nomination and Remuneration Committee **but shall not chair such committee**.

The **quorum for a meeting** of the nomination and remuneration committee shall be **either two members or one third of the members of the committee**, whichever is greater, including at least one independent director in attendance.

The nomination and remuneration committee **shall meet at least once in a year**.

The role of such committee shall include the following:

- (i) **Formulation of the criteria for determining qualifications**, positive attributes and **independence of a director** and recommend to the Board of Directors a policy, relating to the remuneration of the directors, key managerial personnel and other employees;
- (ii) Formulation of criteria for **evaluation of performance of independent directors** and the Board of Directors;
- (iii) Devising a **policy on Board diversity**;
- (iv) **Identifying persons who are qualified to become directors** and who may be appointed in senior management in accordance with the criteria laid down, and recommend to the Board their appointment and removal;
- (v) Whether to **extend or continue the term of appointment of the independent director**, on the basis of the report of performance evaluation of independent directors.
- (vi) **Recommend to the board, all remuneration**, in whatever form, payable to senior management.

Question 21

LDH Ltd., a company incorporated in India and Listed on a recognized Stock Exchange in India has entered into various related parties transactions during the financial year. You are required to answer the following keeping in mind the Listing Obligations and Disclosure Requirements (LODR) on corporate Governance.

- (i) Who should sign the report of material transactions with related parties?
- (ii) What type of transactions and policy are required to be disclosed in relation to related party transactions?
- (iii) Whether disclosures of related party transactions on consolidated financial statements are required to be made? If yes, what are the guidelines?

Answer

The listed entity shall submit a quarterly compliance report on corporate governance in the format as specified by the Board from time to time to the recognised stock exchange(s) within fifteen days from close of the quarter. **Details of all material transactions with related parties shall be disclosed therein.**

- (i) The report shall be signed either by the **compliance officer or the chief executive officer** of the listed entity.
- (ii) The company shall disclose the **policy on dealing with related party transactions** on its website and a web link thereto shall be provided in the Annual Report.
The listed entity shall disclose the **transactions with any person or entity belonging to the promoter/ promoter group which hold(s) 10% or more shareholding** in the listed entity, in the format prescribed in the relevant accounting standards for annual results.
- (iii) The listed entity shall **submit within 30 days from the date of publication** of its standalone and consolidated financial results for the half year, **disclosures of related party transactions on a consolidated basis**, in the format specified in the relevant accounting standards for annual results to the stock exchanges and publish the same on its website.

Chapter - 8

Audit of Consolidated Financial Statements

Question 1

While doing the audit of Consolidated Financial Statements, which current period consolidation adjustments are to be taken into account?

Answer

Current period adjustments are those adjustments that are made in the accounting period for which the consolidation of financial statements is done.

Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including:

- (a) **intra-group interest** paid and received, or management fees, etc.;
- (b) **unrealised intra-group profits on assets** acquired/ transferred from/ to other subsidiaries;
- (c) **record deferred taxes** on unrealised intercompany profits elimination in accordance with Ind AS 12;
- (d) intra-group indebtedness;**
- (e) adjustments related to **harmonising the different accounting policies** being followed by the parent and its components;
- (f) adjustments to the financial statements (of the parent and the components being consolidated) for recognized **subsequent events or transactions** that occur between the balance sheet date and the date of the auditor's report on the consolidated financial statements of the group.

There are two types of subsequent events:

- (i)** The first type of subsequent events consists of events or transactions that provide additional evidence about conditions that existed at the date of the financial statements, including the estimates inherent in the process of preparing financial statements (**i.e. adjusting events**).
- (ii)** The second type of subsequent events consists of events that provide evidence about conditions that did not exist at the date of the financial statements but arose subsequent to that date (**i.e. non-adjusting events**).

Events occurring after balance sheet date which do not require adjustments would not normally require disclosure, although they may be of such significance that they may require a disclosure in the report of approving authority in the case of accounting standards and in the financial statements in case of Ind AS. For such events, the following shall be disclosed:

- (i) The **nature of the event**; and
 - (ii) An **estimate of its financial effect** or a statement that such an estimate cannot be made.
- (g) adjustments for the effects of significant transactions or other events that occur between the date of the components balance sheet and not already recognised in its financial statements and the date of the auditor's report on the group's consolidated financial statements when the financial statements of the component to be used for consolidation are not drawn upto the same balance sheet date as that of the parent;

- (h) **In case of a foreign component, adjustments to convert** a component's audited **financial statements** prepared under the component's local GAAP to the GAAP under which the consolidated financial statements are prepared;
- (i) **determination of movement in equity attributable to the minorities interest**/non-controlling interest since the date of acquisition of the subsidiary. It should also be noted that under Ind AS, non-controlling interest can also result in negative balance. Unlike earlier AS, as per paragraph 28 of Ind AS 27, if the net worth of subsidiary is negative, non-controlling interest could have deficit balance;
- (j) **adjustments of deferred tax on account of temporary differences** arising out of elimination of profit and losses resulting from intragroup transactions and undistributed profits of component in case of consolidated financial statements prepared under Ind AS.

Question 2

Write a short note on:

- (a) Responsibility of holding company for preparation of Consolidated Financial Statements.
- (b) Permanent Consolidated Adjustments.

Answer

- (a) The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:
 - (i) **identifying components**, and including the financial information of the components to be included in the consolidated financial statements;
 - (ii) where appropriate, **identifying reportable segments** for segmental reporting;
 - (iii) **identifying related parties** and related party transactions for reporting;
 - (iv) obtaining **accurate and complete financial information** from components;
 - (v) making **appropriate consolidation adjustments**;
 - (vi) **harmonization of accounting policies** and accounting framework; and
 - (vii) **GAAP conversion**, where applicable.

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

- (b) Permanent consolidation adjustments are those adjustments that are **made only on the first occasion** or subsequent occasions in which there is a change in the shareholding of a particular entity which is consolidated. **Permanent consolidation adjustments are:**
 - (i) Determination of **goodwill or capital reserve** as per applicable accounting standards.
 - (ii) Determination of amount of **equity attributable** to minority/non-controlling interests.

Question 3

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. As a Statutory Auditor, how would you deal?

Answer

Consolidation of Financial Statement: AS 21 “Consolidated Financial Statements”, states that a **subsidiary should be excluded from consolidation** when:

- (i) **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
- (ii) **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 and the investments in such subsidiaries should be accounted for in accordance with AS 13 “Accounting for Investments”.

As per Ind AS 110, there is no such exemption for ‘temporary control’, or “for operation under severe long-term funds transfer restrictions” and **consolidation is mandatory for Ind AS compliant financial statement** in this case. Paragraph 20 of Ind AS 110 states that “Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee”.

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, **where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards**, it shall be **sufficient if the company complies with** the provisions on consolidated financial statements provided in **Schedule III to the Act**.

In the given 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, Therefore, **R Ltd. is not required to prepare consolidated financial statement as per AS 21**, however, for the compliance of provisions related to consolidation of financial statements given under section 129(3) of the Companies Act, 2013 read with Companies (Accounts) Rules, 2014, **R Ltd. is required to make disclosures in the financial statements as per** the provisions provided in **Schedule III** to the Companies Act, 2013.

However, if R Ltd. is required to prepare its financial statements **under Ind AS, it shall have to prepare Consolidated Financial Statements** in accordance with Ind AS 110 as exemption for ‘temporary control’ is not available under Ind AS 110.

Question 4

Moon Ltd. acquired 51% shares of Star Ltd. during the year ending 31-3-2020. During the financial year 2020-21 the 20% shares of Star Ltd. were sold by Moon Ltd. Moon Ltd. while preparing the financial statements for the year ending 31-3-2020 and 31-3-2021 did not consider the financial statements of Star Ltd. for consolidation. As a statutory auditor how would you deal with it?

Answer

Consolidation of Financial Statements: Accounting Standard 21 “Consolidated Financial Statements”, states that a **subsidiary should be excluded from consolidation** when **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.

Audit of CFS

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are acquired & held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be **accounted for in accordance with AS 13 “Accounting for Investments”**.

In the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary is temporary, the **auditor should verify that the intention of the parent, to dispose the subsidiary, in the near future, existed** at the time of acquisition of the subsidiary. The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements.

As per Ind AS 110, there is no such exemption for ‘temporary control’, or “for operation under severe long-term funds transfer restrictions” and consolidation is mandatory for Ind AS compliant financial statement in this case.

However, as per section 129(3) of the Companies Act, 2013 **where a company having subsidiary, which is not required to prepare consolidated financial statements under the applicable Accounting Standards, it shall be sufficient if the company complies with** the provisions on consolidated financial statements provided in **Schedule III to the Act**.

Conclusion: In the given case, Moon Ltd. has acquired 51% shares of Star Ltd. during the year ending 31.03.2020 and sold 20% shares during the year 2020-21. Moon Ltd. did not consolidate the financial statements of Star Ltd. for the year ending 31.03.2020 and 31.03.2021.

The **intention of Moon Ltd. is quite clear that the control in Star Ltd. is temporary** as the former company disposed off the acquired shares in the next year of its purchase. **Therefore, Moon Ltd. is not required to prepare consolidated financial statement as per AS 21** however, for the compliance of provisions related to consolidation of financial statements given under section 129(3) of the Companies Act, 2013, **Moon Ltd. is required to made disclosures** in the financial statements as per the provisions provided in **Schedule III** to the Companies Act’ 2013.

However, if the Moon Ltd. is required to prepare its financial statements **under Ind AS, it shall have to prepare Consolidated Financial Statements in accordance with Ind AS 110** as exemption for ‘temporary control’, or “for operation under severe long-term funds transfer restrictions” is not available under Ind AS 110. Paragraph 20 of Ind AS 110 states that “Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee”.

Question 5

H Limited is an Investment Company preparing its Financial Statements in accordance with Ind AS. The Company obtains funds from various investors and commits its performance for fair return and capital appreciation to its investors. During the year under audit, it had been observed that the Company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the Investee Companies. When checking the investment schedule of the Company, an issue cropped as to whether there would arise any need to consolidate accounts of any such investee companies with those of H Limited in accordance with section 129(3) of the Companies Act, 2013 which contains no exclusion from consolidation. Analyse the issues involved and give your views.

Answer

Consolidated Financial Statements: According to Section 129(3) of the Companies Act, 2013, **where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial**

statement of the company and of all the subsidiaries in the same form and manner as that of its own.

Further, as per Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made **in accordance with the provisions of Schedule III to the Act and the applicable accounting standards**. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

However, an **investment entity need not present consolidated financial statements** if it is required, in accordance with Ind AS 110 'Consolidated Financial Statements', to measure all of its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

(An investment entity is an entity that (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.)

In the given case, H Limited is an investment company preparing its financial statements in accordance with Ind AS and the company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the investee companies. In view of provisions discussed in Ind AS 110, **the Company is not required to prepare consolidated financial statements** however, for the compliance of Companies (Accounts) Rules, 2014, it shall be sufficient if the company **complies with** provisions on consolidated financial statements provided in **Schedule III** of the Act.

Thus, it can be concluded that ultimate authority on consolidation is AS / Ind AS as prescribed by law and if they give some exemption it should be followed. If out of exemption some subsidiaries are not consolidated then list should be disclosed in notes to accounts with reason.

Question 6

A Ltd. holds the ownership of 10% of voting power and control over the composition of Board of Directors of B Ltd. While planning the statutory audit of A Ltd., what factors would be considered by you as the statutory auditors of A Ltd for the audit of its consolidated financial statements prepared under Ind AS?

Answer

10% Voting Power and Control over the composition of Board of Directors: In this case, A Ltd. holds only 10 percent of the voting power but has control over the composition of the Board of Directors of B Ltd.

In such a case, A Ltd shall be considered as a parent of B Ltd and, therefore, it would consolidate B Ltd in its consolidated financial statements as a subsidiary.

The auditor should **verify A Ltd's management's assessment of having control** in B Ltd despite having only 10% voting power as per the requirements of Ind AS 110. Auditor would need to verify as to how A Ltd controls the composition of the Board of Directors or corresponding governing body of B Ltd.

There can be various means by which such kind of control can be established. In this regard, the auditor may verify **the minutes of Board meetings, shareholder agreement** entered into by the parent, agreements with B Ltd to which the parent might have provided any technology or

know how, enforcement of statute, etc.

Further, the auditor should **verify that the adjustments warranted by Ind AS 110 have been made** wherever required and have been **properly authorised by the management of the parent**. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period **consolidation adjustments**. The auditor should make plan, among other things, for the understanding of **accounting policies** of the A Ltd and B Ltd and determining and programming the **nature, timing, and extent of the audit procedures** to be performed etc.

Further, the duties of an auditor with regard to reporting of transactions with any other related parties are given in **SA 550 on Related Parties**. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity are considered as Related Party.

In forming an opinion on the financial statements, the auditor shall evaluate whether the **identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with Ind AS 110 and Schedule III** and whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks) or cause the financial statements to be misleading (for compliance frameworks).

Question 7

You are appointed as an auditor of Nawab Limited, a listed company which is a main supplier to the UK building and construction market. With a turnover of ₹ 2.9 billion, the company operates through 11 business units and has nearly 180 branches across the countries.

As an auditor, how will you draft the report in case:

- (a) When the Parent's Auditor is also the Auditor of all its Components?
- (b) When the Parent's Auditor is not the Auditor of all its Components?
- (c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent?
- (d) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent?
- (e) Where the financial statements of one or more components is not audited?

Answer

- (a) **When the Parent's Auditor is also the Auditor of all its Components:** While drafting the audit report, the auditor should **report whether principles and procedures** for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been **followed**. In case of any **departure or deviation**, the auditor should **make adequate disclosure in the audit report** so that users of the consolidated financial statements are aware of such deviation. Auditor should **issue an audit report expressing opinion whether the consolidated financial statements give a true and fair view** of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit. Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the

consolidated cash flow statements.

- (b) When the Parent’s Auditor is not the Auditor of all its Components:** In a case where the parent’s auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also **consider the requirement of SA 600 “Using the Work of Another Auditor”**.

As prescribed in SA 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor’s report on the consolidated financial statements should **disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s)**. This may be done by stating **aggregate rupee amounts or percentages** of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent’s auditor. Total assets, revenues and cash flows not audited by the parent’s auditor should be presented before giving effect to permanent and current period consolidation adjustments. **Reference** in the report of the auditor on the consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is **not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries**.

- (c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent:** The parent may have components located in multiple geographies outside India applying an accounting framework (GAAP) that is different than that of the parent in preparing its financial statements. Foreign components prepare financial statements under different financial reporting frameworks, which may be a well-known framework (such as US GAAP or IFRS) or the local GAAP of the jurisdiction of the component. Local component auditors may be unable to report on financial statements prepared using the parent’s GAAP because of their unfamiliarity with such GAAP.

When a component’s financial statements are prepared under an accounting framework that is different than that of the framework used by the parent in preparing group’s consolidated financial statements, the parent’s management **perform a conversion of the components’ audited financial statements** from the framework used by the component to the framework under which the consolidated financial statements are prepared. The **conversion adjustments are audited by the principal auditor** to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation.

A component may alternatively prepare financial statements on the basis of the parent’s accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group’s consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group’s consolidated financial statements are prepared. The local component auditor can then audit and issue an audit report on the components financial statements prepared in accordance with “group accounting policies”.

When applying the approach of using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should **perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent’s financial statements**. This ensures that the information prepared under the requirements of the group accounting policies will be directly usable and relevant for the preparation of consolidated financial statements by the parent entity, eliminating the need for auditing by the auditor, the differences between the basis used for the component’s financial statements and that of the consolidated financial statements. The Principal auditor can then decide whether or not to rely on the

components' audit report and make reference to it in the auditor's report on the consolidated financial statements.

- (d) **When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent:** Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("Indian GAAS"). In order to maintain consistency of the auditing framework and to enable the parent auditor to rely and refer to the other auditor's audit report in their audit report on the consolidated financial statements, the **components' financial statements should also be audited under a framework that corresponds to Indian GAAS.**
- (e) **Components Not Audited:** Generally, the financial statements of all components included in consolidated financial statements **should be audited or subjected to audit procedures** in the context of a multi-location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

Where the financial statements of one or more components continue to **remain unaudited**, the auditor reporting on the consolidated financial statements should **consider unaudited components in evaluating a possible modification to his report** on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both **qualitative & quantitative factors** on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Question 8

H Co. Ltd., is a holding company with two subsidiaries R Co. Ltd., and S Co. Ltd. The H Co. Ltd., adopts straight line method of depreciation for its assets whereas S Co. Ltd., follows written down value or diminishing value method. Though R Co. Ltd., follows straight line method of depreciation, it does not give effect to component accounting of depreciation in respect of high value assets. While consolidating the financials of the R Co. Ltd., and S Co. Ltd., with those of H Co. Ltd., determine the possible issues that you have to ensure for compliance in the light of above facts.

Answer

When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework is Different than that of the Parent: A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared. Thus, using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent's financial statements.

It may be noted that **change in the selection of the method of depreciation is an accounting estimate and not an accounting policy** as per Ind-AS 8. Accordingly, the entity should select the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That **method should be applied consistently from period to period** unless there is a change in the expected pattern of consumption of those future economic benefits in separate financial statements as well as consolidated financial statements.

Therefore, there can be different methods for calculation of depreciation for its assets, if their expected pattern of consumption is different. The **method once selected in the stand-alone financial statements of the subsidiary should not be changed while preparing the consolidated financial statements.**

In the given case, assets of R Co. Ltd. (subsidiary company) is depreciated using straight line method, assets of S Co. Ltd. (subsidiary company) are depreciated using written down value method and assets of parent company (H Co. Ltd.) are depreciated using straight line method, is in order. However, each part of an item of Property Plant and Equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately under Component Method of Depreciation as per AS 10 on Property, Plant and Equipment. **Thus, R Co. Ltd., though adopting straight line method but does not giving effect to component accounting of depreciation in respect of high value assets , is not in compliance with Ind AS 16/ Accounting Standard 10 Property Plan and Equipment.**

Question 9

Write short note on Auditor's objectives in an audit of consolidated financial statements.

Answer

The auditor's objectives in an audit of consolidated financial statements are:

- (i) to satisfy himself that the consolidated financial statements have been prepared in accordance with the **requirements of applicable financial reporting framework;**
- (ii) to enable himself to **express an opinion on the true and fair view** presented by the consolidated financial statements;
- (iii) to **enquire into the matters** as specified in **section 143(1)** of the Companies Act, 2013; and.
- (iv) to **report on the matters** given in the clauses (a) to (i) of **section 143(3)** of the Companies Act, 2013, for other matters under section 143(3)(j) read with rule 11 of the Companies (Audit and Auditors) Rules, 2014, to comment on the matters specified in sub-rule (a),(b) and (c)1 to the extent applicable;
- (v) The auditor should also **validate the requirement of preparation of CFS** for the company as per applicable financial reporting framework.

Question 10

Describe the relevance of SA 600 while auditing consolidation of Financial Statements.

Answer

Relevance of SA 600 While Auditing Consolidation of Financial Statements: Standard on Auditing (SA) 600, 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity.

The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, **should comply with the requirements of SA 600.**

In carrying out the **audit of the standalone financial statements**, the **computation of materiality** for the purpose of issuing an opinion on the standalone financial statements of each component **would be done component-wise on a standalone basis. However**, with regard to determination of materiality during the audit of consolidated financial statements (CFS), **the auditor should consider the following:**

Audit of CFS

- The auditor is required to **compute the materiality for the group as a whole**. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.
- The parent auditor can also use the materiality computed on the group level to **determine whether the component's financial statements are material to the group** to determine whether they should scope in additional components, and consider using the work of other auditors as applicable.

However, **while considering the observations** (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the **concept of materiality would not be considered**. Thus, the **component auditor's observations**, if any, on the component's financial statements, irrespective of whether the auditors of the component are also the auditors of the CFS or not, **are required to be included in the parent auditor's report on CFS, regardless of materiality**.

Question 11

Whether preparation of consolidated financial statements is mandatory? If yes, please elaborate on the requirements under the statute.

Answer

According to Section 129(3) of the Companies Act, 2013, where a company **has one or more subsidiaries, including associate company and joint venture**, it shall, in addition to its own financial statements **prepare a consolidated financial statement of the company and of all the subsidiaries** in the same form and manner as that of its own. Further, section 129(4) of the said Act, provides that the provisions applicable to the preparation, adoption and audit of the financial statements of a holding company shall, **mutatis mutandis, also apply** to its the consolidated financial statements.

The consolidated financial statements shall also be **approved by the Board of Directors** before they are signed on behalf of the Board, along with its standalone financial statements and shall **also be laid before the annual general meeting** of the company along with the laying of its standalone financial statement.

The company shall also attach along with its financial statement, a separate statement containing the salient features of the financial statement of its subsidiary(ies) in **Form AOC-1**.

According to the Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the **provisions of Schedule III** to the Act and the applicable accounting standards. **However, a company which is not required to prepare consolidated financial statements under the Accounting Standards**, it shall be **sufficient if** the company **complies with** provisions of consolidated financial statements provided in **Schedule III** of the Act [refer Appendix given at the end of Chapter 5 for Schedule III].

However, the requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:

- (i) it is a **wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members**, including those not otherwise entitled to vote, having been **intimated in writing** and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;
- (ii) it is a company whose **securities are not listed or are not in the process of listing** on any stock exchange, whether **in India or outside India**; and

- (iii) **its ultimate or any intermediate holding company files consolidated financial statements with the Registrar** which are in compliance with the applicable Accounting Standards.

Question 12

Please elaborate on the situations wherein the requirement related to preparation of consolidated financial statements may not apply.

Answer

The requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:

- (i) it is a **wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members**, including those not otherwise entitled to vote, having been **intimated in writing** and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;
- (ii) it is a company whose **securities are not listed or are not in the process of listing** on any stock exchange, whether **in India or outside India**; and
- (iii) **its ultimate or any intermediate holding company files consolidated financial statements with the Registrar** which are in compliance with the applicable Accounting Standards.

Question 13

M Ltd. acquired 51 % shares of S Ltd. on 01-04-2020 and sold 25% of these shares during the financial year 2020-21. M Ltd. did not prepare Consolidated Financial Statements for the financial year 2020-21 on the plea that the control was only temporary. Do you agree with the view of M Ltd.? Decide, assuming, that M Ltd. is required to prepare its financial statements under Ind AS.

Answer

Consolidation of Financial Statement: As per **Ind AS 110**, there is **no such exemption for ‘temporary control’, or “for operating under severe long-term funds transfer restrictions”** and consolidation is mandatory for Ind AS compliant financial statement in this case.

Ind AS 110 states that “Consolidation of an investee shall **begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee”**.”

In the given case, M Ltd acquired 51% shares of S Ltd on 01.04.2020 and sold 25% shares during the year ended 2020-21. M Ltd did not consolidate the financial statements of S Ltd for the year ended 31.03.2021 on the plea that control was only temporary. The intention of M Ltd. is quite clear that the **control in S Ltd. is temporary** as the former company disposed off the acquired shares in the same year of its purchase.

However, **even though the intention of M Ltd. is for temporary holding of shares** in S Ltd. as per Ind AS, **M Ltd is required to prepare Consolidated Financial Statements** in accordance with Ind AS 110 as exemption for ‘temporary control’ is not available under Ind AS 110. However, “Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee”. Here, due to sale of

investment in S Ltd. up to 25%, M Ltd. loses control of S Ltd.

Accordingly, M Ltd., is required to prepare consolidated statement till the date of disposal of the 25% shares to comply with the same.

Question 14

CA.Vimal is the auditor of Excellent Ltd., a parent company which presents Consolidated Financial Statements. The management of Excellent Ltd. has provided the list of the components included in the Consolidated Financial Statements. As an auditor of Consolidated Financial Statements, CA Vimal has to verify that all the components have been included in the Consolidated Financial Statements and review the information provided by the management in identifying the components. State the procedures to be followed by CA. Vimal in respect of completeness of this information.

Answer

Procedures to be followed by CA. Vimal in respect of completeness of this information:

- | |
|--|
| (a) review his working papers for the prior years for the known components; |
| (b) review the parent's procedures for identification of various components; |
| (c) make inquiries of the management to identify any new components or any component which goes out of consolidated financial statements; |
| (d) review the investments of parent as well as its components to determine the shareholding in other entities; |
| (e) review the joint ventures and joint arrangements as applicable; |
| (f) review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group; |
| (g) review the statutory records maintained by the parent , for example registers under section 186, 190 of the Companies Act, 2013; |
| (h) Identify the changes in the shareholding that might have taken place during the reporting period. |

Chapter 9

Audit of Banks

Question 1

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:

- (a) The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.
- (b) The bank is a consortium member of Cash Credit Facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing.

Answer

- (a) It is not a prudent practice to treat dividend on shares of corporate bodies and units of mutual funds as income unless these are actually received. Accordingly, income from dividend on shares of corporate bodies and units of mutual funds should be booked on cash basis. In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government. Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9 as well. In the instant case, therefore, the recognition of income by the bank on accrual basis is not in order.
- (b) The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest, the credits in X Ltd's account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

Question 2

Banks, because of certain characteristics, are distinguished from other commercial enterprises and hence it needs special audit consideration.

As an auditor of a bank, specify the various peculiarities which may necessitate special audit consideration to be taken care by you.

Answer**Special audit considerations arise in the audit of banks because of:**

- (i) the particular **nature of risks associated** with the transactions undertaken;
- (ii) the **scale of banking operations** and the resultant significant exposures which can arise within short period of time;
- (iii) the **extensive dependence on IT** to process transactions;
- (iv) the effect of the **statutory and regulatory requirements**;
- (v) the **continuing development of new products and services** and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices;
- (vi) **Evolution of technology** and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk.

The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditor and SCAs to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.

Question 3

Write a short note on reversal of income under bank audit.

Answer

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

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

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

Question 4

While auditing FAIR Bank, you observed that a lump sum amount has been disclosed as contingent liability collectively. You are, therefore, requested by the management to guide them about the disclosure requirement of Contingent Liabilities for Banks.

Answer

Contingent Liabilities for Banks: The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet-

(A) Contingent liabilities

- (i) **Claims against the bank not acknowledged as debts.**
- (ii) Liability for **partly paid investments.**
- (iii) Liability on account of **outstanding forward exchange contracts.**
- (iv) **Guarantees** given on behalf of constituents-
 - (1) In India.
 - (2) Outside India.
- (v) **Acceptances, endorsements and other obligations.**
- (vi) **Other items** for which the bank is contingently liable.

(B) Bills for collection.

Question 5

In course of audit of Good Samaritan Bank as at 31st March, 2021 you observed the following:

- (1) In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government?
- (2) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances.

Answer

- (1) **Government Guaranteed Advance:** If a government guaranteed advance becomes NPA, then for the purpose of income recognition, **interest on such advance should not be taken to income unless interest is realized.** However, for purpose of asset classification, credit facility backed by **Central Government Guarantee**, though overdue, **can be treated as NPA only when the Central Government repudiates its guarantee**, when invoked.

Since the bank has not revoked the guarantee, the question of repudiation does not arise. Hence the **bank is correct to the extent of not applying the NPA norms** for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the **income to the extent not recovered should be reversed.**

The situation would be different if the advance is guaranteed by State Government because this **exception is not applicable for State Government Guaranteed advances**, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

- (2) **The Audit Programme to Verify Advances against Life Insurance Policies is as under-**
 - (i) The auditor should **inspect the policies** and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.
 - (ii) The auditor should also examine **whether premium has been paid on the policies** and whether they are in force.
 - (iii) **Certificate regarding surrender value obtained** from the insurer should be examined.
 - (iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the **amount of such premium has been deducted from the**

surrender value.

Question 6

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.

Answer

The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Inspector and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB). In determining the scope, importance should be given to **checking high-risk transactions having large financial implications** as opposed to transactions involving lesser amounts. The **detailed scope** of the concurrent audit may be **determined and approved by the ACB**.

Further, the guidelines issued by the RBI cover all the key areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the **following areas are covered by these guidelines**:

- **Cash**
- **Deposits**
- **Advances**
- **Investments**
- **Foreign Exchange**
- **House Keeping**
- **Other Items**

Question 7

ABC Chartered Accountants have been appointed as concurrent auditors for the branches of Effective Bank Ltd. for the year 2020-21. You are part of the audit team for Agra branch of the bank and have been instructed by your senior to verify the advances of the audit period. You are required to guide your assistant about the areas to be taken care while doing verification during the concurrent audit.

Answer

Verification of Advances as a Concurrent Auditor:

- (i) Ensure that loans and advances have been **sanctioned properly** (i.e. after due scrutiny and at the appropriate level).
- (ii) Verify whether the sanctions are in accordance with **delegated authority**.
- (iii) Ensure that **securities and documents** have been received and properly charged/registered.
- (iv) Ensure that **post disbursement supervision and follow-up is proper**, such as receipt of stock statements, instalments, renewal of limits, etc.
- (v) Verify whether there is **any mis-utilisation** of the loans and whether there are instances indicative of diversion of funds.
- (vi) Check whether the **letters of credit** issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.

- (vii) Check the **bank guarantees issued**, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.
- (viii) Ensure **proper follow-up of overdue bills of exchange**.
- (ix) Verify whether the **classification of advances** has been done as per RBI guidelines.
- (x) Verify whether the **submission of claims to DICGC and ECGC is in time**.
- (xi) Verify that **instances of exceeding delegated powers** have been promptly reported to controlling/Head Office by the branch and have been got confirmed or ratified at the required level.
- (xii) Verify the **frequency and genuineness** of such exercise of authority beyond the delegated powers by the concerned officials.

Question 8

In the course of audit of Skip Bank Ltd., you found that the Bank had sold certain of its non-performing assets. Draft the points of audit check that are very relevant to this area of checking.

Or

CA K have been' doing audit of branch of LUD Bank Ltd. The principal business of the branch is lending advances to large corporates. Since last one year, many large accounts have become Non-Performing Asset (NPA) as per guidelines. The Management of the Bank decided to sell one of the NPA account and consequently one NPA namely DEF Ltd. amounting to 10.00 Crores was sold to Asset Reconstruction Company. What audit points CA K should keep in mind while doing audit of this transaction?

Answer

Sale of Non-Performing Assets: In case of Sale of NPA by Bank, the auditor should examine:

- the **policy laid down by the Board of Directors** in this regard relating to procedures, valuation and delegation of powers.
- that **only such NPA has been sold which has remained NPA** in the books of the bank for **at least 2 years**.
- the assets have been sold/ purchased "**without recourse**" only.
- subsequent to the sale of the NPA, the bank does **not assume any legal, operational or any other type of risk** relating to the sold NPAs.
- the NPA has been **sold at cash basis** only.
- the bank has **not purchased an NPA which it had originally sold**.
- that on the **sale of the NPA, the same has been removed** from the books of the account.
- that the **short fall in the net book value** has been charged to the profit and loss account.
- that where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss because sale of other non-performing financial assets.

Question 9

You are the Concurrent Auditor of a Branch of Nationalized Bank which deals in foreign exchange transactions. Give focus areas of your checking in this respect.

Answer**Focus Areas in case of Foreign Exchange Transactions:**

- Check **foreign bills** negotiated under letters of credit.
- Check **FCNR and other non-resident accounts** whether the debits and credits are permissible under rules.
- Check whether inward/outward **remittance** have been **properly accounted** for.
- Examine **extension and cancellation of forward contracts** for purchase and sale of foreign currency. Ensure that they are duly authorised and necessary charges have been recovered.
- Ensure that **balances in Nostro accounts** in different foreign currencies are **within the limit** as prescribed by the bank.
- Ensure that the **overbought/oversold position** maintained in different currencies is **reasonable** considering the foreign exchange operations.
- Ensure **adherence to the guidelines issued by RBI/HO** of the bank about dealing room operations.
- Ensure verification/**reconciliation of Nostro and Vostro account** transactions/ balances.

Question 10

You have been appointed as an auditor of LCO Bank, a nationalized bank. LCO Bank also deals in providing credit card facilities to its account holder. The bank is aware of the fact that there should be strict control over storage and issue of credit cards. How will you evaluate the Internal Control System in the area of Credit Card operations of a Bank?

Answer**Evaluation of the Internal Control System in the area of Credit Card Operations of a bank:**

- (i) There should be **effective screening** of applications with reasonably good credit assessments.
- (ii) There should be strict control over **storage and issue of cards**.
- (iii) There should be a system whereby a merchant confirms the status of **unutilised limit of a credit-card** holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
- (iv) There should be a system of **prompt reporting** by the merchants of all settlements accepted by them through credit cards.
- (v) **Reimbursement to merchants** should be made only after verification of the validity of merchant's acceptance of cards.
- (vi) All the reimbursement (**gross of commission**) should be immediately charged to the customer's account.
- (vii) There should be a system to ensure that **statements are sent regularly and promptly** to the customer.
- (viii) There should be a system to **monitor and follow-up customers' payments**.
- (ix) **Items overdue** beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through **periodic bulletins**, as early as possible, to avoid increased losses.
- (x) There should be a system of **periodic review of credit card holders' accounts**. On this basis, the **limits of customers may be revised**, if necessary. The review should also include

determination of doubtful amounts and the provisioning in respect thereof.

Question 11

As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?

Answer

Special points which are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements:

- Obtain an **understanding of the relevant circulars/ instructions of the RBI**, particularly regarding composition of items of DTL.
- **Request the branch auditors to send their weekly trial balance** as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him/her. The branch auditors should also be specifically requested to **examine the cash balance at the branch on the selected dates**.
- Examine, on a test basis, the **consolidations regarding DTL position** prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the **valuation of securities** done by the bank is in accordance with the guidelines prescribed by the RBI.
- While examining the computation of DTL, specifically examine that **the following items have been excluded from liabilities-**
 - **Part amounts of recoveries** from the borrowers in respect of debts considered bad and doubtful of recovery.
 - Amounts received in Indian currency **against import bills** and held in sundry deposits pending receipts of final rates.
 - **Un-adjusted deposits**/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
 - **Margins held** and kept in sundry deposits for funded facilities.
- Similarly, specifically examine that the **following items have been included in liabilities-**
 - **Net credit balance in branch adjustment accounts** including these relating to foreign branches.
 - **Interest on deposit** as at the end of the firm half year reversed in the beginning of the next half-year.
 - **Borrowings from abroad** by banks in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'
 - The **reconciliation of Nostro accounts** (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on

behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.

- Examine whether the **consolidations prepared by the bank** include the relevant information in respect of all the branches.
- It may be noted that, even though interest accrues daily, it is recorded in the books only at periodic intervals. Thus, examine whether such **interest accrued but not accounted for** in books is included in the computation of DTL.
- The auditor at the central level should **apply the audit procedures listed above to the overall consolidation** prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in the report.
- While reporting on compliance with SLR requirements, the auditor should **specify the number of unaudited branches** and state that he/she has relied on the returns received from the unaudited branches in forming an opinion. Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this.

Question 12

Advances generally constitute the major part of the assets of the bank. There are substantial number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

As an expert in bank audit, you are required to briefly discuss the area of focus and suggested audit procedures regarding evaluation of internal controls over advances, substantive audit procedures and recoverability of advances.

Answer

Audit Procedures -In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

Area of Focus	Suggested Audit Procedures
Evaluation of Internal Controls over Advances	<ul style="list-style-type: none"> • Examine loan documentation; • Examine the validity of the recorded amounts; • Examine the existence, enforceability and valuation of the security; • Ensure compliance with the terms of sanction and end use of funds. • Ensure compliance with Loan Policy of Bank as well as RBI norms including appropriate classification and provisioning • Review the operation of the accounts;

Substantive Procedures	Audit	<ul style="list-style-type: none"> • Check that amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet. • Check that advances represent amount due to the bank. • Verify that amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances. • Ensure there are no unrecorded advances. • Check that the stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation. • Verify that the advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements. • Check that appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices. • Examine all large advances while other advances may be examined on a sample basis • Verify completeness and accuracy of interest being charged
Recoverability of Advances		<ul style="list-style-type: none"> • Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions. • Review latest financial statements of borrowers. • Review reports on inspection of security. • Review Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rupees 10 lakh or above for working capital from the banking system.

Question 13

ABC Bank had sanctioned credit limits of Rs.100 lakh to M/s Volkart Ltd on 1st September 2019. The renewal of limits was due on 1st September 2020. While doing the statutory branch audit for the year ended 31st March 2021, you find that the renewal has not been done even though 180 days are over. The bank says that the renewal process has been initiated on time and most of the document are received. The account is operated regularly and is in order; balance is maintained within drawing power. It also shows a letter from Volkart stating that due to a sudden death of their auditor, a new auditor had to be appointed. Procedure for appointment took some time and the new auditor was doing the audit all over again. The limit was not renewed till 31/3/2021. However, the audited financials are received on 10th April 2021 and the renewal letter was issued immediately. Your assistant is insisting that the account must be classified as NPA since the limit was not renewed as on 31/3/2021. What is your opinion?

Answer

As per Guidelines of Reserve Bank of India the account should be **classified as NPA if renewal is not done in 180 days**. However, in the present case, operations in the **account are excellent**. The bank has shown a letter from that company that due to certain reasons the audited financial statements are delayed. Further, **the limit has been renewed before signing the audit report**.

Thus, even if the sanction was issued after the balance sheet date, it relates to the position as on the balance sheet date. Therefore, **it is an adjusting event under AS 4**, Contingencies and Events Occurring After the Balance Sheet Date. It is also a matter of substance over form.

The auditor would consider classifying the account as a standard asset.

Question 14

You are auditing a small bank branch with staff strength of the manager, cashier and three other staff S1, S2 and S3. Among allocation of work for other areas, S1 who is a peon also opens all the mail and forwards it to the concerned person. He does not have a signature book so as to check the signatures on important communications. S2 has possession of all bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which you have test checked also. However, no one among staff regularly checks that. You are informed that being a small branch with shortage of manpower, it is not possible to always check the work and records. Give your comments.

Answer

Banks are required to **implement and maintain a system of internal controls for mitigating risks**, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are violated in the given situation:

In the instant case, S1 who is a peon opens all the mail and forwards it to the concerned person.

Further, he **does not have a signature book** so as to check the signatures on important communications is not in accordance with implementation and maintenance of general internal control. As the mail should be opened by a responsible officer. **Signatures on all the letters and advices** received from other branches of the bank or its correspondence **should be checked by an officer with the signature book.**

All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) **should be kept in the possession of an officer**, and another responsible officer should verify the issuance and stock of such stationery. In the given case, S2 has possession of all bank forms (e.g. cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He **maintains a record meticulously** which were also verified on test check basis.

Further, **contention of bank** that being a small branch with shortage of manpower they are not able to check the work and records on regular basis, is **not tenable** as such lapses in internal control pose risk of fraud.

The auditor should report the same in his report accordingly.

Question 15

ABN Bank was engaged in the business of providing Portfolio Management Services to its customers, for which it took prior approval from RBI. Your firm has been appointed as the statutory auditors of the Bank's financial statements for the year 2020-21. Your senior has instructed you to verify the transactions of Portfolio Management Services (PMS). While verifying the transactions you noticed that the bank has not maintained separate record for PMS transactions from the Bank's own investments. As a statutory auditor what methodology will be adopted by you for verification of PMS transactions?

Answer

Separation of Investment Functions: The auditor **needs to examine** whether the bank, as required by the RBI, is **maintaining separate accounts for the investments** made by it on their own Investment Account, **PMS clients' account**, and on behalf of other Constituents (including brokers). As per the RBI guidelines, **banks are required to get their investments under PMS separately audited by external auditors.**

Thus, in the instant case, ABN Bank is required to prepare separate records for PMS and as per RBI guidelines PMS investments need to be audited separately by the external auditors and the auditors are required to give a certificate separately for the same. **So, in the above case the auditor should not verify the PMS transactions and advise the bank to segregate the PMS transactions from its own investments** and provide the certificate of external auditor as described above. In case ABN Bank does not provide the same the auditor may report accordingly.

Question 16

In the course of statutory Branch audit of KS Bank Ltd, you observe that some borrower accounts have been regularised before Balance sheet date by payment of overdue amount. Narrate the audit procedures to be carried out with special focus on the Classification of advances and Provisioning for Non-Performing assets of the Branch.

Answer

Audit procedures to be carried out for Classification of advances and Provisioning for Non-Performing assets of the Branch:

- Examine whether the **classification made by the branch is appropriate.** Particularly, examine the classification of advances where there are **threats to recovery.**
- Examine whether the **secured and the unsecured portions of advances** have been **segregated correctly** and provisions have been calculated properly.

As per the Reserve Bank guidelines, **if an account has been regularised** before the balance sheet date by payment of overdue amount through genuine sources, the **account need not be treated as NPA.** Where, subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should **carefully assess whether the repayment was out of genuine sources or not.** Where the account indicates inherent weakness based on the data available, the account should be deemed as a NPA. In other genuine cases, the banks must furnish satisfactory evidence to the Statutory Auditors about the manner of regularisation of the account to eliminate doubts on their performing status.

It is to be ensured that the **classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date.** The date of NPA is significant to determine the classification and hence specific care be taken in this regard. **NPA should be recognized only based on concept of Past Due/ Overdue concept,** and not based on the Balance Sheet date.

Chapter 10

Audit of Insurance Companies

Audit of Life Insurance Companies

Question 1

Briefly explain the term policy lapse and revival in case of Life Insurance Company and role of auditor in verifying the same.

Answer

Policy Lapse and Revival: "Lapse" is the **discontinuance of the policy owing to non-payment of premium dues**. The term "**lapse**" is not defined in the insurance legislation, except stating that "a policy which has acquired a surrender value shall be kept alive to the extent of the paid up sum assured" - vide section 113(2) of the Insurance Act, 1938.

In order to keep a life insurance policy "in force" the policy holder is required to pay premiums when due (either monthly/ quarterly/annual/bi-annual). **If payment is missed, the insurer allows a period of 15/30 days from the premium due date for making the payment. This period is termed as "grace period". If the policy holder does not make the payment within the grace period, the policy gets "lapsed"**. Thus, a payment within the grace period is deemed to be a payment on the due date.

Lapsation affects all the stakeholders – the policy holder, agents and the insurer. A lapsed policy ceases to provide insurance protection to the insured. It forfeits the benefits under the policy and cost of new policy is higher. Agents do not get renewal premium commission if the policy is lapsed.

The **terms and conditions** of the policy stipulate, that where the premium is not paid within the grace period, the policy lapses but may be revived during the life time of the life assured. Some insurers do not allow revival, if the policy has remained in lapsed condition for more than five years. This is because of the possibility that the arrears of premiums on such a policy would be too heavy and that it would be better to take out a fresh policy.

The insurer should have taken **persistent measures for monitoring receipt of renewal premium within the due dates**. In case of most of insurers, policy lapsation is tracked over the PMS, wherein premium due dates are monitored by the system once initial data of the policy is entered in the system.

Role of Auditor: The primary objective of the audit is to check and confirm that **due dates are recorded and monitored properly and policies are marked as "lapsed" on non-receipt of renewal premium** within due dates/grace period. In case of revival request, whether adequate checks are in place for receipt of outstanding amounts and **adequate documents** are obtained before reviving the policy.

Question 2

Briefly discuss the importance and role of auditor with respect to actuarial process for Life Insurance business.

Or

What is the 'Actuarial Process' in Life Insurance Business and what is the role of Auditor with

respect to the same?

Answer

Importance of Actuarial Process and Role of Auditor in case of Life Insurance Business:

Importance of Actuarial Process: Actuaries in Life Insurance business have gained tremendous importance. The **role of Actuary** in life insurance has **shifted from supervising compliance to certify whether products and financial reports are in accordance with the general regulatory guidelines.**

The job of actuary or actuarial department in any Life Insurance Company involves, **detailed analysis of data to quantify risk.** The actuarial department is **calculating and modelling hub of the Company.** Within the department fundamentals of Insurance business is determined from pricing to policy valuations techniques.

Role of Auditor: Auditors in the Audit report are required to certify, **whether the actuarial valuation of liabilities is duly certified by the appointed actuary,** including to the effect that the **assumptions for such valuation** are in accordance with the guidelines and norms, if any, issued by the authority and/or the Actuarial Society of India in concurrence with the IRDA. Hence, Auditors generally rely on the Certificate issued by the Appointed Actuary, certifying the Policy liabilities. However, Auditor may discuss with the Actuaries with respect to process followed and assumptions made by him before certifying the Policy liabilities.

Actuarial department broadly concentrates following key areas of Insurance business:

- Product Development/ Pricing and Experience analysis.
- Model Development.
- Statutory Valuations and reserving.
- Business Planning.
- Solvency management.
- Management reporting on various business valuations and profitability models of the Life Insurance business.

Question 3

Auditors should evaluate various sub-processes, employed by the Insurance Companies in accounting of premiums like collection of premium from the policy holders, booking of premium, banking, accounting and reconciliation of the same. In view of above, you are required to briefly discuss some illustrative points, auditors are required to follow during the Audit of Accounting of Premiums in case of Life Insurance Companies.

Answer

Following are the certain illustrative points, Auditors are required to follow during the Audit of Accounting of Premiums:

1. Collection of Premium:

- Check whether there is **daily reconciliation process** to reconcile the amounts collected, entered into the system and deposited into the bank.
- Check that there is **appropriate mechanism** to ensure all the collections are deposited into the Bank on timely basis.

2. Calculation of Premium:

- Check that **Accounting system**, employed by the Company, calculates premium amounts and its respective due dates correctly.

- Check that system employed as such is equipped to **calculate all types of premium modes correctly.**

3. Recognition of Income:

- Check that **premium is recognised only on the basis of 'Issued Policies'** and not on underwriting dates.
- Check that there is inbuilt mechanism the system all the premium collected are correctly allocated all various components of the Policies.
- Check that there is appropriate mechanism in place to conduct **reconciliation on daily basis** and reconciling items, if any, are rectified/ followed up.

4. Accounting of 'Advance Premium':

- Check, whether system has capability to **identify regular and advance premium.**
- Check whether there is a process of applying advance premium to a contract when premium is due.

5. Reporting of Premium figures to IRDA/ Management:

- Check the **methodology for generation of MIS** from the system and there is no manual intervention.
- Check the **procedure for Maker/ Checker** before finalising the MIS.
- Check whether there is a reconciliation process between premium Income as per financials and as reported.

6. Other Areas:

- Check whether there are **appropriate SOPs developed by the Companies** and are strictly followed by all the departments/ branches of the Company.
- Ensure duly approved Delegation of Authority parameters matrix already in place for authorisation limits.
- Premium **recognition and refund of premium** are independent processes with adequate segregation of duties amongst the personnel.
- Check that the Company conducts premium reconciliation on daily basis.
- Check the **robustness of interface between administration and accounting system.**

Auditors may also refer to IRDA (Preparation of Financial Statements & Auditors Report of Insurance Companies) Regulations, 2000 for premium accounting.

Question 4

What are the Auditor's considerations while reviewing of Investment Department of Life Insurance Company?

Or

ABC & Co., Chartered Accountants are the Auditors of Just Care Life Insurance Company Limited. Enumerate the steps to be taken by the auditor while verifying the "Investment".

Answer

Role of Auditor: The Auditor during his review of Investment Department of Life Insurance Company should mainly consider the following:

- Review the **Investment management structure** to ensure adequate segregation of duties between Investment Front office, Mid Office and Back office.

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- Review of **insurer's Standard Operating Procedures** which are prescribed by the IRDA Regulations and are required to cover the entire gamut of investment related processes and policies.
- Review of insurer's **Investment policy**.
- Review of functioning and scope and **minutes of Investment Committee**.
- **Compliance of all Investment regulations**, various other circulars specified by IRDA and other regulations specified in the Insurance Act, 1938.
- Review of insurer's **Disaster Recovery, Backup and Contingency Plan**.
- Review of access Controls, authorization process for Orders and Deal execution, etc.
- Review of insurer's **Cash Management System** to track funds available for Investment considering the settlement obligations and subscription and redemption of units, etc. The system should be validated not to accept any commitment beyond availability of funds and restrict Short Sales at the time of placing the order. Further insurer's system should be able to determine the amount of Investible surplus.
- Ensure that the system is be able to **automatically monitor various Regulatory limits** on Exposure and Rating of debt instruments.
- Review of **fund wise reconciliation with Investment Accounts**, Bank, and Custodian records.
- Ensure that there is **split between Shareholders' and Policyholders' funds**, and earmarking of securities between various funds namely Life (Participating & Non-Participating), Pension & Group (Participating & Non-Participating) and Unit Linked Fund.
- Review the arrangements and reconciliations of holdings with the **insurer's custodian**.
- Review and check insurer's **Investment Accounting and valuation policy** and the controls around this process.
- Insurer's risk management policies and processes to manage investment risk such as Market risk, Liquidity risk, Settlement risks, etc.
- Determine the **extent of activities outsourced** and the controls over such activities.
- Controls over **NAV computation** and declaration.
- Controls over various system interfaces such as Seamless integration of data, between front office and back office, in the Investments accounting system.
- **Flow of data from PMS** to the Investment Accounting system.
- **Controls around personal dealings**, insider trading and front running.

Question 5

As an auditor of Life Insurance Company, how will you verify the 'Commission Payable' to its Agents?

Answer

Commission payable to Agent: Insurance business is **generally solicited by the Insurance agents**. The remuneration of agent is paid by way of commission which is calculated by applying percentage to premium collected by him. Agency commission contributes towards significant portion of expenses incurred by the Insurance Commission. Commission is **payable towards**

generation of new business and towards settlement of renewal premium

Role of Auditor: The Auditor during his review of Commission paid to Agents should mainly consider the following:

- Review the **system established by the Insurer** with respect to **calculation of commission** to eligible agents accurately and processing the same in timely manner.
- Review the **commission payment system** is in sync with the premium collection system.
- Check whether **commission paid is within the limit** prescribed under Insurance Act.
- Check whether **commission is clawed-back** on the cancelled policies.
- Check the **completeness of commission processing system**.

Question 6

Write a short note on difference between Life Insurance and General Insurance.

Answer

Life Insurance	General Insurance
Life Insurance can be seen as an investment apart from insurance as it offers maturity benefits after specific tenures	General Insurance, mostly, doesn't give any maturity benefits but promises payout in case of loss due to unavoidable circumstances
Term may be fixed or variable .	Term is fixed (usually 1 year) .
Pay-outs are certain either as claims or maturity benefits.	Pay-outs are uncertain as claims may or may not arise.
Multi-purpose (e.g. investment, tax benefits, insurance).	Solely for the purpose of insurance .

Question 7

Explain different types of Life Insurance Products.

Answer

Types of Life Insurance Products

Term/Protection: Term life Insurance is traditional form of Life Insurance Product. Term Insurance generally takes care of pure income replacement needs rather than Capital appreciation requirements. Term Insurance covers the policy holder for specific period and pays the death benefits only if the policy holder dies during the policy period.

Endowment/Pure Endowment: Endowment policies cover the risk for a specified period and at the end of the policy the sum assured is paid back to the policyholder along with all bonus accumulated during the policy term.

Money Back Plan: Money Back policies are type of Endowment policies which provides periodic payments of partial benefits during the term of policy so long as the policy holder is alive. Peculiar nature of these policies is that, in event of death at any time during policy term, the death claim would comprise of full sum assured without deduction of any survival benefit amounts. Also, bonus

is calculated on sum assured.

Whole Life Insurance Product: It provides cover throughout the life time of the person. Unlike Endowment plans they do not carry any maturity value and sum assured is paid to the family in case of unfortunate death of the policyholder.

Unit Linked Insurance Plan (ULIP): Unit Linked Insurance Plans are such Insurance plans where the value of the policy changes as per the underlying Investment Assets. It allows protection and flexibility in Investment. The Premium paid is used for the purchase of units in Investment assets.

Pension or Retirement Plans: A pension plan is retirement solution where policyholder decides the age retirement age and agrees to pay premium till the time of the retirement and thereafter he has option to commute the a part of his fund value and take an annuity for the balance. Pension plan provides Income protection as well as the Life Cover.

Annuities: Annuity is a contract where Insurer in return for the payment at regular intervals till fixed date make series of agreed payments at regular intervals from fixed date.

Group Insurance: Group Insurance is an insurance that covers a group of people, who are the members of the societies, employees of an organisation or professionals in common group.

Question 8

TNT Limited is engaged in the Life Insurance business. The company's operations have been considerable in the Northern India and its Head Office is also based at New Delhi. TNT Ltd. while preparing financial statements have classified administrative expenses under 14 heads as mentioned in Schedule 3 forming part of financial statements given under schedule A to IRDA Regulations, 2002. What is your responsibility as an auditor particularly in relation to administrative/expenses of management?

Answer

Responsibility of an auditor particularly in relation to administrative expenses of management:

The auditor should ensure that these **expenses are first aggregated and then apportioned to the Revenue Account** of each class of business on a **reasonable and equitable basis**. The **accounting policy should clearly indicate the basis of apportionment** of these expenses to the respective Revenue Accounts (i.e., Participating and Non-participating policies and in between Linked and Non- Linked business) **along with the certificate that all expenses of management**, wherever incurred, directly or indirectly, read with the accounting policy, have been fully debited to the respective Revenue Account as expenses.

Audit of General Insurance Companies

Question 9

As at 31st March 2021 while auditing Safe Insurance Ltd, you observed that a policy has been issued on 25th March 2021 for fire risk favouring one of the leading corporate houses in the country without the actual receipt of premium and it was reflected as premium receivable. The company maintained that it is a usual practice in respect of big customers and the money was collected on 5th April, 2021. You further noticed that there was a fire accident in the premises of the insured on 31st March 2021 and a claim was lodged for the same. The insurance company also made a provision for claim. Please advise.

Answer

Provision for Claim: No risk can be assumed by the insurer **unless the premium is received**. According to section 64VB of the Insurance Act, 1938, **no insurer should assume any risk in India** in respect of any insurance business on which premium is ordinarily payable in India **unless** and until the **premium payable is received or is guaranteed to be paid by such person** in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The **premium receipt** of insurance companies carrying on general insurance business normally arise out of **three sources**, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

In view of the above, the insurance company is not liable to pay the claim and hence no provision for claim is required.

Question 10

You have been appointed as an auditor of ABC Insurance Co. Ltd. and found that M/s PQR Ltd. got their Plant & Machinery insured on 01-10-2020 but the amount of premium has been paid by them on 15-10-2020. In the meanwhile, on 10-10-2020 a fire has broken out in the factory and the company filed a claim for damages of plant & machinery with the Insurance Company. Advise the insurance company in this regard.

Answer

No Risk Assumption without Premium: No risk can be assumed by the insurer **unless the premium is received**. According to section 64VB of the Insurance Act, 1938, **no insurer should assume any risk in India** in respect of any insurance business on which premium is ordinarily payable in India **unless** and until the **premium payable is received or is guaranteed to be paid by such person** in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The **premium receipt** of insurance companies carrying on general insurance business normally arise out of **three sources**, viz., premium received from direct business, premium received from reinsurance business and the share of co- insurance premium.

Therefore, in the instant case, PQR Ltd. signed the insurance documents on 01.10.2020 but did not paid the premium. In case of non-payment of insurance premium if any accidental incident occurs insurance company will have no liability to pay claim. In the given case, fire is occurred on 10th October, 2020 in factory and premium has been paid on 15 October 2020, **the ABC Insurance Company Ltd. will not be liable for claim for damages of plant and machinery.**

Question 11

Mr. Bhavya is appointed as an auditor of General Insurance Company limited. State the verification procedure to be followed by Mr. Bhavya in case of outstanding premium and agent's balances.

Or

State the procedure for verification of Agents' Balances in the course of audit of a General Insurance Company.

Answer

General Insurance Company – Verification of Outstanding Premium and Agents' Balances:

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

- (i) Scrutinise and **review control account debit balances** and their nature should be enquired into.
- (ii) Examine **inoperative balances and treatment given for old balances** with reference to company rules.
- (iii) Enquire into the **reasons for retaining the old balances**.
- (iv) Verify **old debit balances which may require provision or adjustment**. Notes of explanation may be obtained from the management in this regard.
- (v) Check **age-wise, sector-wise analysis** of outstanding premium.
- (vi) Verify whether **outstanding premiums have since been collected**.
- (vii) Check the **availability of adequate bank guarantee** or premium deposit for outstanding premium.

Question 12

Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.

Answer

The following steps may be taken by the auditor in the **verification of re-insurance outward**:

- (i) The auditor should verify that **re-insurance underwriting returns** received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.
- (ii) The auditor should check whether the **pattern of re-insurance underwriting for outward cessions** fits within the parameters & guidelines applicable to the relevant year.
- (iii) The auditor should also check whether the **cessions have been made as per the stipulation** applicable to various categories of risk.
- (iv) The auditor should verify whether the **cessions have been made as per the agreements** entered into with various companies.
- (v) It should also be seen whether the **outward remittances to foreign re-insurers** have been done as per the foreign exchange regulations.

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- (vi) It should also be seen whether the **commission on cession** has been calculated as per the terms of the agreement with the re-insurers.
- (vii) The auditor should verify the **computation of profit commission** for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (viii) The auditor should examine whether the **cash loss recoveries** have been claimed and accounted on a regular basis.
- (ix) The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.
- (x) He should see whether **provisioning for outstanding losses recoverable on cessions** have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.
- (xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
- (xii) The auditor should **check percentage pattern** of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
- (xiii) The auditor should also check that the **re-insurers balance on cessions** and whether the sub ledger balances tallies with the general ledger balances.
- (xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning / write off or write back.
- (xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
- (xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-a-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.
- (xvii) **Any major event after the Balance Sheet date** which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re- insurance balances will need to be brought out suitably.

Question 13

Amrapali & Co., Chartered Accountants are the Auditors of Natural Care General Insurance Company Limited. As on March 31, 2021 the Management made a provision for claims outstanding. Enumerate the steps to be taken by the Auditor while verifying the "Claims Provision".

Answer

Verification of "Claims Provision" in the Case of a General Insurance Company: The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims. The auditor should satisfy himself that the estimated liability provided for by the management is adequate with reference to the relevant claim files/dockets, keeping in view the

following:

- (i) that **provision has been made for all unsettled claims** as at the year-end on the basis of claims lodged/communicated by the parties against the company. The date of loss (and not the date of communication thereof) is important for recording/ recognizing the claim as attributable to a particular year.
- (ii) that provision has been made for **only such claims** for which the company is **legally liable**, considering particularly, (a) that the risk was covered by the policy, if in force, and the claims arose during the currency of the policy; and (b) that claim did not arise during the period the company was not supposed to cover the risk.
- (iii) that the **provision made is normally not in excess of the amount insured** except in some categories of claims where matters may be sub-judice in legal proceedings which will determine the quantum of claim, the amount of provision should also include survey fee and other direct expenses.
- (iv) that in determining the amount of provision, **events after the balance sheet date have been considered.**
- (v) that the **claims status reports** recommended to be prepared by the Divisional Manager on large claims outstanding at the year-end have been reviewed with the contents of relevant files or dockets for determining excess/short provisions.
- (vi) that in determining the amount of provision, the **'average clause'** has been applied in case of under-insurance by parties.
- (vii) that the **provision made is net of payments made** 'on account' to the parties
- (viii) wherever such payments have been booked to claims.
- (ix) that in case of **co-insurance** arrangements, the company has made provisions only in respect of its **own share** of anticipated liability.
- (x) that wherever an unduly long time has elapsed after the filing of the claim and there has been no further communication and no litigation or arbitration dispute is involved, the reasons for carrying the provision have been ascertained.
- (xi) that wherever **legal advice has been sought** or the claim is under litigation, the provisions is made according to the legal advisor's view and differences, if any, are explained.
- (xii) that in the case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits are stated separately as assets and provisions are not made net of such deposits.
- (xiii) that **no contingent liability** is carried in respect of any claim intimated in respect of policies issued.
- (xiv) that the claims are provided for net of estimated salvage, wherever applicable.
- (xv) that **intimation of loss is received within a reasonable time** and reasons for undue delay in intimation are looked into.
- (xvi) that provisions have been retained as at the year-end in respect of guarantees given by company to various Courts for claims under litigation.
- (xvii) that due provision has been made in respect of claims lodged at any office of the company other than the one from where the policy was taken, e.g., a vehicle insured at Mumbai having met with an accident at Chennai necessitating claim intimation at one of the offices of the company at Chennai.

In cases of material differences in the liability estimated by the management and that which ought to be provided in the opinion of the auditor, the same must be brought out in the auditor's report after obtaining further information or explanation from the management.

Question 14

You are the Auditor of Good Luck General Insurance Company. You want to ensure that there exists good system that effectively serves the requirements of true and accounting of claim-related expenses and liabilities. Suggest how this can be ensured.

Answer

Verifications of Claims: The auditor should satisfy himself that the estimated liability provided for by the management is adequate with reference to the relevant claim files/dockets, keeping in view the following:

- (i) that **provision has been made for all unsettled claims** as at the year-end on the basis of claims lodged/communicated by the parties against the company.
- (ii) Insurance companies normally have an **'initial provision' or 'default provision'** based on a pre-determined formula or on a primary assessment of the damage by a surveyor. The auditor would need to review the pre-determined formula to ensure that initial reserving made is adequate.
- (iii) that provision has been made for **only such claims** for which the company is **legally liable**.
- (iv) that the **provision made is normally not in excess of the amount insured** except in some categories of claims where matters may be sub-judice in legal proceedings.
- (v) that in determining the amount of provision, **events after the balance sheet date have been considered**.
- (vi) that the **claims status reports** recommended to be prepared by the Divisional Manager on large claims outstanding at the year-end have been reviewed with the contents of relevant files or dockets for determining excess/short provisions.
- (vii) that in determining the amount of provision, the **'average clause'** has been applied in
- (viii) case of **under-insurance by parties**.
- (ix) that the provision made is net of payments made 'on account' to the parties wherever
- (x) such payments have been booked to claims.
- (xi) that in case of **co-insurance** arrangements, the company has made provisions only in respect of its **own share** of anticipated liability.
- (xii) that wherever an unduly long time has elapsed after the filing of the claim and there has been no further communication and no litigation or arbitration dispute is involved, the reasons for carrying the provision have been ascertained.
- (xiii) that wherever **legal advice has been sought** or the claim is under litigation, the
- (xiv) provision is made according to the **legal advisor's view**.
- (xv) that in the case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits are stated separately as assets and provisions are not made net of such deposits.
- (xvi) that **no contingent liability** is carried in respect of any claim intimated in respect of policies issued.
- (xvii) that the claims are provided for net of estimated salvage, wherever applicable.
- (xviii) that **intimation of loss is received within a reasonable time** and reasons for undue delay in intimation are looked into.

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- (xix) that provisions have been retained as at the year end in respect of guarantees given by company to various Courts for claims under litigation.
- (xx) that due provision has been made in respect of claims lodged at any office of the company other than the one from where the policy was taken.

Claims Paid - The auditor may determine the extent of checking of claims paid on the same line as suggested for outstanding claims. Other aspects in respect of claims paid to be examined by the auditors are as follows:

- (i) that **in case of co-insurance** arrangements, **claims** paid have been **booked only** in respect of **company's share** and the balance has been debited to other insurance companies.
- (ii) that in case of claims paid on the basis of advices from other insurance companies (where the company is not the leader in co-insurance arrangements), whether share of premium was also received by the company.
- (iii) that the claims payments have been **duly sanctioned** by the authority concerned and the payments of the amounts are duly acknowledged by the claimants.
- (iv) that the **salvage recovered has been duly accounted** for in accordance with the procedure applicable to the company and a letter of subrogation has been obtained in accordance with the laid down procedure.
- (v) that the **amounts of the nature of pure advances/deposits** with Courts, etc., in matters under litigation/arbitration have **not been treated as claims** paid but are held as assets till final disposal of such claims.
- (vi) that **payment made against claims partially settled** have been duly vouched.
- (vii) that in case of final settlement of claims, the claimant has given an **unqualified discharge note**, not involving the company in any further liability in respect of the claim; and
- (viii) that the figures of claims, wherever communicated for the year by the Division to the Head Office for purposes of reinsurance claims, have been reconciled with the trial balance-figure.
- (ix) that payments have been made within 30 days of the receipt of the last document received.

Question 15

You have been appointed to carry out the audit of Sky Insurance Company Ltd. for the year 2020-21. In the course of your audit, you observed that the commission paid to agents constituted a major expense in operating expenses of the Company. Enumerate the audit concerns that address to the assertions required for the Auditor to ensure the continued existence of internal control as well as fairness of the amounts in accounting of commission paid to agents.

Answer

Commission: The commission is the consideration payable for getting the insurance business. The term 'commission' is used for the payment of consideration to get Direct business. Commission received on amount of premium paid to a re-insurer is termed 'Commission on reinsurance accepted' and is reduced from the amount of commission expenditure. The internal control with regard to commission is aimed at ensuring that commission is paid in accordance with the rules and regulations of the company and in accordance with the agreement with the agent, commission is paid to the agent who brought the business and the legal compliances, for example, tax deduction at sources, GST on reverse charge mechanism and provisions of the Insurance Act, 1938 have been complied with.

Role of Auditor: The auditor should, inter alia, do the following for verification of commission:

Audit of Insurance Companies

- Ensure that commission is **not paid in excess of the limits specified by IRDAI**
- Ensure that **commission is paid as per rates with the agent** and rates filed with IRDAI
- Ensure that commission is **paid to the agent/broker** who has **solicited the business**
- Ensure that the **agent is not blacklisted by IRDAI** and is not terminated for fraud etc.
- **Vouch disbursement entries** with reference to the disbursement vouchers with copies of commission bills and commission statements.
- Check whether the **vouchers are authorized by the officers-in-charge** as per rules in force and income tax is deducted at source, as applicable.
- Test check **correctness of amounts of commission allowed.**
- **Scrutinize agents' ledger and the balances**, examine accounts having debit balances, if any, and obtain information on the same. Necessary rectification of accounts and other remedial actions have to be considered.
- Check whether **commission outgo** for the period under audit been **duly accounted.**

Question 16

Your audit assistant seeks your help in checking the claim liability of Bharat Insurance Co. Ltd. and wants to know the registers and records which they should obtain and review in this regard.

Answer

Registers and Records -The following register and records are generally prepared in respect of claims:

(i) Claims Intimation Register;
(ii) Claims Paid Register;
(iii) Claims Disbursement Bank Book ;
(iv) Claims Dockets , normally containing the following records: Claim intimation, claim form, particulars of policy, survey report , Photograph showing damage, repairer's bills, letter of subrogation, police report (in case of theft), fire service report, claim settlement note, claim satisfaction note, salvage report, salvage disposal note, claims discharge voucher, etc.;
(v) Report of quality assurance team ; and
(vi) Salvage register.

Question 17

M/s MPS & Associates, Chartered Accountants started the statutory audit of their client Contingencies Ltd., a General Insurance company, which has a paid-up capital of ₹ 16,800/- lac. During the course of the audit, it was found that the Company was not maintaining the required solvency margin as per the provisions of Insurance Act, 1938. When the issue was escalated to the management, they replied that solvency margin needs to be maintained as per limits prescribed only on last day of the financial year. Comment whether reply of management is tenable or not.

Answer

Maintenance of Solvency Margin: Section 64VA of the Insurance Act, 1938 as amended by Insurance Laws (Amendment) Act, 2015 requires **every insurer and re-insurer to maintain an excess of the value of assets over the amount of liabilities at all times which shall not be less than 50% of the amount of minimum capital** as stated under section 6 (requirement as to capital) of the Act and arrived at in the manner specified by the regulations.

If, at any time, an insurer or re-insurer **does not maintain the required control level of solvency margin, he is required to submit a financial plan to the Authority** indicating the plan of action to correct the deficiency. If, on consideration of the plan, the Authority finds it inadequate, the insurer has to modify the financial plan.

Sub-section (2) of section 64VA states that **if an insurer or re-insurer fails to comply with the prescribed requirement of maintaining** excess of value of assets over amount of liabilities, it shall **deemed to be insolvent and may be wound up by the Court** on an application made by the authority.

Therefore, in the said case Contingencies Ltd has not maintained the Solvency Margin throughout the year. Accordingly, **contention of Contingencies Ltd.** that solvency margin is required to be maintained as per limits prescribed only on last day of the financial year **is not tenable.**

Question 18

Write a short note on - Facultative reinsurance under Insurance Act, 1938.

Answer

Facultative Reinsurance: It is that type of reinsurance whereby the **contract relates to one particular risk** and is expressed in the reinsurance policy. This is the **oldest method of reinsurance and it necessitates consideration of each risk separately.** Each transaction under facultative reinsurance has to be **negotiated individually.** Each party to the transaction has a **free choice**, i.e., for the ceding company to offer and the reinsurer to accept. The **main drawbacks** of this type of insurance are **the volume of work involved and time taken to cover the risk.** It is, however, still used even today, mainly when:-

- (i) **automatic covers** have already been **exhausted.**
- (ii) the **risk is excluded** from the Treaties.
- (iii) the insurer does not want his **reinsurance treaties overburdened** with particularly heavy and abnormal risks.
- (iv) the insurer has **no automatic cover at his disposal** in a particular branch, where he issues policies rarely.
- (v) the **nature of business is such that technical guidance or consultation with the reinsurer is required at every stage** of acceptance of the risk itself or for a type of business where the number of risks is very small, for example, in atomic energy installations, oils rigs, etc.

Question 19

Explain the difference between the Proportional Treaties and Non Proportional Treaties?

Answer

Difference between Proportional Treaties and Non Proportional Treaties:

Proportional Treaties –

- (i) Proportional treaties are based on **pro-rata apportionment of the sum insured**, premium and losses, according to a pre-determined percentage/ratio.
- (ii) These treaties can be further classified as **Quota Share Treaty, Surplus Treaty, Auto- Fac Treaty and pools.**

Non-Proportional Treaties –

- (i) Non-Proportional treaties are characterised by a **distribution of liability between the ceding company and the reinsurer on the basis of losses** rather than the sum insured, as is the case in proportional reinsurance.
- (ii) Non-Proportional Treaties can be further classified into **Excess of Loss Treaties, Excess of Loss Cover on Prevent basis, Excess of Loss cover on Non-Prevent basis, Stop Loss Treaties.**

Question 20

State the disclosure requirements in respect of contingent liabilities in the notes to the Balance Sheet of a General Insurance Company.

Answer

Disclosure Requirements in Respect of Contingent Liabilities in the Notes to the Balance Sheet of a General Insurance Company: The following shall be disclosed by way of notes to balance sheet in respect of Contingent Liabilities-

- (i) **Partly paid up investments.**
- (ii) **Underwriting Commitments outstanding.**
- (iii) **Claims**, other than those under policies, not acknowledged as debts.
- (iv) **Guarantees** given by or on behalf of the Company.
- (v) **Statutory demands/Liabilities in dispute**, not provided for.
- (vi) **Reinsurance obligations** to the extent not provided for in the accounts.
- (vii) **Others** (to be specified).

Question 21

Explain “Trade credit insurance policy” and basic requirements of a trade credit insurance product.

Answer

“Trade Credit insurance policy” is a **conditional insurance contract between two parties** (insurer and seller) that cannot be traded and is always directly related to an underlying trade transaction, which is either the delivery of goods or of services. The correct fulfilment of this trade transaction and satisfaction of the contract terms is essential for credit cover to exist.

Basic Requirements of a Trade Credit Insurance Product: An insurer shall offer trade credit insurance product only if all requirements mentioned below are met -

- (i) Policyholder's loss is non-receipt of trade receivable arising out of a **trade of goods or services.**

- (ii) Policyholder is a supplier of goods or services in consideration for a **fair market value**.
- (iii) Policyholder's trade receivable does **not arise out of factoring** or reverse factoring arrangement or any other similar arrangement.
- (iv) **Policyholder has a customer (i.e. Buyer) who is liable to pay a trade receivable** to the policyholder in return for the goods and services received by him from the policyholder, in accordance with a policy document filed with the insurer.
- (v) Policyholder **undertakes to pay premium for the entire Policy Period**.
- (vi) **Any other requirement** that may be specified by the Authority from time to time.

Question 22

You have been appointed as an auditor of a General Insurance Company. In this context, explain unexpired risks reserve and audit procedures for the same.

Answer

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**. Many policies normally extend beyond this date into the following year during which risks continue. In other words, **at the closing date, there is unexpired liability under various policies** which may occur during the remaining term of the policy beyond the year end.

As per section 64V of the Insurance Act, 1938, for the purpose of compliance with the provisions of maintaining control level of solvency margin, **a proper value of every item of liability of the insurer shall be placed** in the manner as may be specified by the regulations made in this behalf.

It may be mentioned that the profit and gain of insurance companies are governed by the provisions of section 44 of the Income Tax Act, 1961. In this regard, Rule 5 of the First Schedule to the Income Tax Act-Computation of Profit & Loss of General Insurance Business provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the Income Tax Rules, 1962. According to this Rule, the **insurance companies are allowed a deduction of 50 per cent of net premium income in respect of Fire and Miscellaneous Business and 100 per cent of the net premium income relating to Marine Insurance business**.

The auditor should **verify the collections lodged by agents after the balance sheet date** to see whether any collection pertains to risk commencing for the year under audit.

The auditor should **also check that the premium has been recorded originally at the gross figure**, i.e., without providing for unexpired risks and reinsurances.

Chapter 11

Audit of Non-Banking Financial Companies

Question 1

Define NBFC. Also give a brief description about types of NBFCs covering any five NBFCs.

Answer

Definition of NBFC: 45 I(f) of Reserve Bank of India (Amendment) Act, 1997 defines a non-banking financial company as:

- (i) A **financial institution** which is a company;
- (ii) A **non-banking institution** which is a company with **principal business of receiving of deposits**, under any scheme or arrangement or in any other manner, or lending in any manner;
- (iii) **Such other non-banking institution** or class of such institutions, **as the Reserve Bank** with the previous approval of the Central Government **may specify** by notification in the Official Gazette.

The **different NBFCs** are as follows:

- Investment and Credit Company (ICC)
- Infrastructure Finance Company (IFC)
- Systemically Important Core Investment Company (CIC-ND-SI)
- Infrastructure Debt Fund (IDF-NBFC)
- Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI)
- Non-Banking Financial Company – Factors (NBFC-Factors)
- Non-Operative Financial Holding Company - (NOFHC)

Investment and Credit Company (ICC): Investment and Credit Company means any company which is a financial institution carrying on as its **principal business - asset finance**, the providing of finance whether by making loans or advances or otherwise for any activity other than its own and the acquisition of securities; and is not any other category of NBFC as defined by the RBI in any of its Master Directions.

Infrastructure Finance Company (IFC): A company which has **net owned funds** of at least ₹ 300 crore and has **deployed 75% of its total assets in Infrastructure loans** is called IFC provided it has credit rating of A or above and has a CRAR of 15% (with a minimum Tier I capital of 10 %).

Systemically Important Core Investment Company (CIC-ND-SI): Core Investment Companies (CIC) having **total assets of not less than ₹ 100 crores either individually or in aggregate** along with other CICs in the group and which raises or holds public funds are called as Systemically Important Core Investment Companies (CICs-ND-SI).

Infrastructure Debt Fund (IDF-NBFC): IDF-NBFC means a non-deposit taking Non-Banking Financial Company that has:

- a) **net owned funds of ₹ 300 crore or more; and**
- b) which **invests only in Public Private Partnerships (PPP) and post commencement operations date (COD)** infrastructure projects which have completed at least one year of satisfactory commercial operation and becomes a party to a Tripartite Agreement.

Non-Banking Financial Company – Micro Finance Institution (NBFC-MFI): NBFC-MFI is a non- deposit taking NBFC which has **at least 85% of its assets in the form of microfinance**. Such microfinance should be in the form of loan given to those who have annual income of ₹

1,00,000 in rural areas and ₹ 160,000 in urban or semi urban areas. Such loans should not exceed ₹ 1,00,000 and its tenure should not be less than 24 months. Further, the loan has to be given without collateral. Loan repayment is done on weekly, fortnightly or monthly installments at the choice of the borrower.

Question 2

Shubham & Associates are going to start the audit of NBFCs. They have not performed much work for the NBFCs in the past years. You are required to explain the requirements related to registration and regulation of NBFCs which an auditor needs to keep in his mind while planning the audit of NBFC which would help this firm.

Answer

An auditor should know following points regarding registration and regulation of NBFCs:

Under Section 45-IA of the RBI Act, 1934, **no NBFC shall commence or carry on the business of a non-banking financial institution without**

- obtaining a **certificate of registration** issued by the RBI; and
- having a **net owned fund (NOF) of ₹ 25 lakhs** (₹ Two crore since April 1999) not exceeding two hundred lakhs rupees, as the RBI may, by notification in the Official Gazette, specify.

(The RBI (Amendment) Act (1997) provided an entry point norm of ₹ 25 lakh as the **minimum NOF** which was **revised upwards to ₹ 2 crore** for new NBFCs seeking grant of certificate of registration (CoR) on or after 21 April 1999).

[Upper limit in relation to NOF requirement for commencing NBFC business has been increased from ₹ 2 crores to ₹ 100 crores as per Finance (No.2) Bill 2019].

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45-IA of the RBI Act, 1934 can **apply** to the RBI **in prescribed form along with necessary documents** for registration. The RBI issues CoR after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock Broking Companies registered with SEBI, Insurance Company holding a valid CoR issued by IRDA, Nidhi Companies as notified under Section 406 of the Companies Act, 2013, Chit Companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The **RBI has issued directions to NBFCs** on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

Question 3

Kamna & Co LLP, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this NBFC and have also an limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his report so that they can conclude their work. Please explain.

Answer

Obligation of auditor to submit an exception report to the RBI

1. Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company **has not complied with:**
 - (a) the **provisions of Chapter III B of RBI Act** (Act 2 of 1934); or
 - (b) **Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;** or
 - (c) **Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.**

It shall be the obligation of the auditor to make a report containing the **details of such unfavourable or qualified statements and/or about the non-compliance**, as the case may be, in respect of the company to the concerned **Regional Office of the Department of Non-Banking Supervision of the RBI** under whose jurisdiction the registered office of the company is located as per first Schedule to the Non- Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

2. The **duty of the Auditor** under sub-paragraph (I) **shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions** referred to in sub-paragraph (1) and such report **shall not contain any statement with respect to compliance** of any of those provisions.

Question 4

In the case of companies carrying on the business of a non-banking financial institution, the auditor needs to report under CARO, 2016 whether the registration has been obtained under section 45-IA of the Reserve Bank of India Act, 1934, if required.

You are required to state in brief the audit procedure to be followed while reporting under above mentioned circumstances.

Answer

Reporting under CARO, 2016 for Registration under RBI Act, 1934: As per Clause (xvi) of paragraph 3 of the CARO, 2016, the auditor is required to report whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934. If so, whether the registration has been obtained.

Audit Procedures and Reporting-

- (i) The auditor should **examine the transactions of company** with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.
- (ii) The financial statements should be examined to ascertain whether **company's financial**

assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

- (iii) Whether the company has **net owned funds as required** for the registration as NBFC.
- (iv) Whether the company has **obtained the registration as NBFC**, if not, the reasons should be sought from the management and documented.

Question 5

Write a short note on Classification of Frauds by NBFC

Answer

Classification of Frauds by NBFC: In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:

- (i) **Misappropriation and criminal breach of trust.**
- (ii) **Fraudulent encashment** through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- (iii) **Unauthorised credit facilities** extended for reward or for illegal gratification.
- (iv) **Negligence and cash shortages.**
- (v) **Cheating and forgery.**
- (vi) **Irregularities in foreign exchange transactions.**
- (vii) **Any other type of fraud** not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be **reported as fraud if the intention to cheat/ defraud is suspected/ proved**. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

- (i) cases of **cash shortages more than ₹ 10,000/-** and
- (ii) cases of **cash shortages more than ₹ 5000/-** if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs having **overseas branches/offices** should **report all frauds perpetrated at such branches/offices** also to the Reserve Bank as per the prescribed format and procedures.

Question 6

You are appointed as the auditor of a NBFC which is an Investment company registered with RBI. What shall be the special points to be covered for the audit of NBFC in case of Investment companies?

Answer

Special points that may be covered in the audit of NBFCs in case of Investment Companies are given below:

- (i) **Physically verify all the shares and securities held by a NBFC.** Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.
- (ii) NBFC Prudential Norms stipulates that NBFCs **should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower.** The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25%

respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. **Verify that the credit facilities extended and investments** made by the concerned NBFC are in accordance with the **prescribed ceiling**.

- (iii) Verify whether the NBFC has **not advanced any loans against security of its own shares**.
- (iv) Verify that **dividend income** wherever declared by a company, has been **duly received** by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for.
- (v) Test check bills/**contract notes received from brokers** with reference to the prices vis-à-vis the stock market quotations on the respective dates.
- (vi) Verify the **Board Minutes for purchase and sale of investments**. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.
- (vii) Check whether the **investments** have been **valued in accordance with NBFC Prudential Norms Directions** and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.
- (viii) Obtain a list of subsidiary/group companies from the management and **verify the investments made in subsidiary/group companies** during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- (ix) Check whether **investments in unquoted debentures/bonds** have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.
- (x) An auditor will have to ascertain whether the requirements of **AS 13 "Accounting for Investments"** (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
- (xi) In respect of shares/securities held through a depository, obtain **a confirmation from the depository** regarding the shares/securities held by it on behalf of the NBFC.
- (xii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities and provision for the return including pre-mature return of the securities deposited/lent.
- (xiii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)
- (xiv) Verify **charges received or paid** in respect of securities lent/borrowed.
- (xv) Obtain a **confirmation from the approved intermediary** regarding securities deposited with/borrowed from it as at the year end.

Question 7

Shivam & Co LLP are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited this NBFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to audit of NBFC - Investment and Credit Company (NBFC-ICC).

Answer**Some points that may be covered in the audit of NBFC - Investment and Credit Company (NBFC-ICC):**

- i. **Physically verify all the shares and securities held by a NBFC.** Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.
- ii. Verify whether the NBFC has **not advanced any loans against the security of its own shares.**
- iii. Verify that **dividend income** wherever declared by a company, has been **duly received** by an NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General Meeting and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.
- iv. Test check bills/**contract notes received from brokers** with reference to the prices vis-à-vis the stock market quotations on the respective dates.
- v. Verify the **Board Minutes for purchase and sale of investments.** Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.
- vi. Check whether the **investments** have been valued **in accordance with NBFC Prudential Norms Directions** and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.
- vii. Obtain a list of subsidiary/group companies from the management and verify the **investments made in subsidiary/group companies** during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.
- viii. Check whether **investments in unquoted debentures/bonds** have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.
- ix. An auditor will have to ascertain whether the requirements of **AS 13 "Accounting for Investments"** or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.
- x. In respect of shares/securities held through a depository, obtain a **confirmation from the depository** regarding the shares/securities held by it on behalf of the NBFC.
- xi. Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).
- xii. Verify **charges received or paid** in respect of securities lend/borrowed.
- xiii. Obtain a **confirmation from the approved intermediary** regarding securities deposited with/borrowed from it as at the year end.
- xiv. An auditor should examine whether each **loan or advance has been properly sanctioned.** He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.
- xv. An auditor should verify the **security obtained and the agreements** entered into, if any,

with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.

- xvi. **Obtain balance confirmations** from the concerned parties.
- xvii. As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.
- xviii. Check whether the NBFC has **not lent/invested in excess of the specified limits** to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.
- xix. An auditor should verify whether the NBFC has an **adequate system of proper appraisal and follow up of loans & advances**. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
- xx. **Check the classification of loans and advances** (including bills purchased and discounted) made by a NBFC **into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets** and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.

Question 8

Differences between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III

Answer

Differences between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III –The **presentation requirements** under Division III for NBFCs are **similar** to Division II (Non NBFC) to a large extent **except for the following**:

- (i) NBFCs have been allowed to present the items of the balance sheet in **order of their liquidity** which is not allowed to companies required to follow Division II. Additionally, NBFCs are required to classify items of the balance sheet into **financial and non-financial** whereas other companies are required to classify the items into **current and non-current**.
- (ii) An NBFC is required to separately disclose by way of a **note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income**. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds **1 per cent of the revenue from operations or ₹10 lakhs, whichever is higher**.
- (iii) NBFCs are required to separately disclose under **'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member**.
- (iv) NBFCs are also required to disclose items comprising **'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss** instead of as part of the notes.
- (v) **Separate disclosure of trade receivable** which have significant increase in credit risk & credit impaired.
- (vi) The **conditions or restrictions for distribution attached to statutory reserves** have to be **separately disclose** in the notes as stipulated by the relevant statute.

Question 9

Mr. G. has been appointed as an auditor of LMP Ltd., a NBFC company registered with RBI. Mr. G is concerned about whether the format of financial statements prepared by LMP Ltd. is as per notification issued by the Ministry of Corporate Affairs (MCA) dated October 11, 2018. The notification prescribed the format in Division III under Schedule III of the Companies Act, 2013 applicable to NBFCs complying with Ind-AS. Mr. G wants to know the differences in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Help Mr. G.

Answer

Differences between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III –The Ministry of Corporate Affairs (MCA) vide notification dated October 11, 2018 introduced Division III under Schedule III of the Companies Act, 2013, wherein a format for preparation of financial statements by NBFCs complying with Ind- AS has been prescribed.

The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

- (i) NBFCs have been allowed to present the items of the balance sheet in **order of their liquidity** which is not allowed to companies required to follow Division II. Additionally, NBFCs are required to classify items of the balance sheet into **financial and non-financial** whereas other companies are required to classify the items into **current and non-current**.
- (ii) An NBFC is required to separately disclose by way of **a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income**. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds **1 per cent of the revenue from operations or .10 lakhs, whichever is higher**.
- (iii) NBFCs are required to separately disclose under **'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member**.
- (iv) NBFCs are also required to disclose items comprising **'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of as part of the notes**.
- (v) **Separate disclosure of trade receivable** which have significant increase in credit risk & credit impaired.
- (vi) The **conditions or restrictions for distribution attached to statutory reserves** have to be **separately disclose** in the notes as stipulated by the relevant statute.

Question 10

You are appointed as the auditor of a NBFC registered with the RBI and which is accepting and holding public deposits. You are considering your reporting requirement in addition to your report made under Section 143 of the Companies Act, 2013 on the accounts of this NBFC as per the prescribed Directions.

Please explain what points are required to be known in respect of separate report to be given by you to the Board of Directors of this NBFC.

Answer

In the case of a non-banking financial companies accepting/holding public deposits

The auditor shall include a statement on the following matters, namely-

- (i) Whether the **public deposits accepted by the company** together with other borrowings

indicated below viz.

- (a) **from public** by issue of unsecured non-convertible debentures/bonds;
 - (b) **from its shareholders** (if it is a public limited company); and
 - (c) **which are not excluded from the definition of 'public deposit'** in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;
- (ii) Whether the public deposits held by the company **in excess of the quantum of such deposits permissible** to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 are regularised in the manner provided in the said Directions;
 - (iii) Whether the non-banking financial company is **accepting "public deposit" without minimum investment grade credit rating** from an approved credit rating agency as per the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;
 - (iv) Whether the **capital adequacy ratio as disclosed in the return** submitted to the Bank in terms of the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 has been **correctly determined** and whether such ratio is in **compliance with the minimum CRAR** prescribed therein;
 - (v) In respect of non-banking financial companies referred to in clause (iii) above,
 - (a) whether the **credit rating**, for each of the fixed deposits schemes that has been **assigned by one of the Credit Rating Agencies** listed in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 is in force; and
 - (b) whether the **aggregate amount of deposits outstanding** as at any point during the year has **exceeded the limit** specified by the such Credit Rating Agency;
 - (vi) Whether the company has **violated any restriction on acceptance of public deposit** as provided in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;
 - (vii) Whether the company has **defaulted in paying to its depositors the interest and /or principal amount** of the deposits after such interest and/or principal became due;
 - (viii) Whether the company has **complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts**, and concentration of credit/investments as specified in the Directions issued by the Bank in terms of the Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;
 - (ix) Whether the company has **complied with the liquid assets requirement** as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the RBI in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

- (x) Whether the company has **furnished to the RBI within the stipulated period the return on deposits** as specified in the NBS 1 to – Non- Banking Financial Company Returns (Reserve Bank) Directions, 2016;
- (xi) Whether the company has **furnished to the RBI within the stipulated period the quarterly return on prudential norms** as specified in the Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;
- (xii) Whether, **in the case of opening** of new branches or offices to collect deposits or in the case of **closure of existing branches/offices** or in the case of **appointment of agent**, the company has **complied with the requirements** contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

Question 11

Karma Pvt Ltd is a Non-Deposit Taking Non-Systemically Important NBFC registered with Reserve Bank of India. The Statutory Auditor of the company is required to give a report to the Board of Directors. What shall be the content of the Auditor's Report to the Board.

Answer

The statutory auditor of Karma Pvt Ltd, being a Non-Deposit Taking Non-Systemically Important NBFC is required to submit separate report to the Board of Directors on the matters as specified as below:

- I. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI is an offence under chapter V of the RBI Act, 1934. Therefore, if the company is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the RBI's press release dated April 08, 1999, and directions issued by DNBR, auditor shall **examine whether the company has obtained a Certificate of Registration (CoR) from the RBI.**
- II. In case of a company holding CoR issued by the RBI, **whether that company is entitled to continue to hold such CoR** in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.
- III. Whether the non-banking financial company is **meeting the required net owned fund requirement** as laid down in Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Apart from the aspects enumerated above, the auditor shall include a statement on the **following matters**, namely: -

- (i) Whether the Board of Directors has passed a **resolution for non- acceptance of any public deposits**;
- (ii) Whether the company has **accepted any public deposits** during the relevant period/year;
- (iii) Whether the company has **complied with the prudential norms** relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial Company – Non-

Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016;

Where, in the auditor's report, the **statement regarding any of the items referred to matters specified above is unfavourable or qualified**, the auditor's report shall also state the **reasons for such unfavourable or qualified statement**, as the case may be. Where the auditor is unable to express any opinion on any of the items referred above, his report shall indicate such fact together with reasons thereof.

Question 12

Krishna Pvt Ltd is primarily into the business of selling computer parts. However, the company is fulfilling the Principal Business Criteria as at the balance sheet date i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50% of Gross Income. What shall be the obligation of the Statutory Auditor in such a scenario?

Answer

In the given case, Krishna Pvt Ltd is fulfilling the Principal Business Criteria i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50 % of Gross Income. **The company which fulfils both these criteria shall qualify as an NBFC and hence is required to obtain Certificate of Registration (CoR) with Reserve Bank of India.** In such a scenario, the statutory auditor has an obligation to submit exception report to the RBI on the following matters:

- (I)** Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016, is **unfavourable or qualified, or in the opinion of the auditor the company has not complied with:**
- (a) the **provisions of Chapter III B of RBI Act (Act 2 of 1934);** or
 - (b) **Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;** or
 - (c) **Non-Banking Financial Company - Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.**

It shall be the **obligation of the auditor to make a report containing the details of such unfavourable or qualified statements** and/or about the non-compliance, as the case may be, in respect of the company **to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI** under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

- (II)** The duty of the Auditor under sub-paragraph (I) **shall be to report only the contraventions of the provisions** of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report **shall not contain any statement with respect to compliance of any of those provisions.**

Question 13

Abhimanyu Finance Ltd. is a Non Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,50,00,000/-(one crore fifty lakhs) and was not having registration certificate from RBI and applied for it on 30th March 2021. The company appointed Mr. Kabra as its statutory auditors for the year 2020-21. Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2016?

Answer

As per Clause (xvi) of Paragraph 3 of CARO 2016, the auditor is required to report that “**whether the company is required to be registered under section 45 -IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.**”

The auditor is required to **examine whether the company is engaged in the business which attract the requirements of the registration.** The registration is required where the financing activity is a principal business of the company. The RBI restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.

Audit Procedures and Reporting:

- (i) The auditor should **examine the transactions of the company** with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.
- (ii) The **financial statements should be examined** to ascertain **whether company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.**
- (iii) Whether the **company has net owned funds as required** for the registration as NBFC.
- (iv) Whether the **company has obtained the registration as NBFC, if not, the reasons** should be sought from the management and documented.
- (v) The auditor should report incorporating the following:-
 - (1) Whether the **registration is required** under section 45-IA of the RBI Act, 1934.
 - (2) If so, whether it has **obtained** the registration.
 - (3) If the registration **not obtained, reasons** thereof.

Question 14

You are the auditor of IJK Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it.

Answer

Compliance of Prudential Norms by NBFC

- (i) The auditor has to verify the compliance of prudential norms relating to **(1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.**
- (ii) The auditor shall ensure that **Board of the NBFC shall frame a policy** for granting

demand/call loans and implement the same.

- (iii) The auditor should **verify the classification of advances** and loans as standard/substandard/doubtful/loss and that **proper provision** has been made in accordance with the directions.
- (iv) Auditor should ensure that **unrealised income from non-performing assets** has not been taken to Statement of Profit and Loss.
- (v) The auditor should **check all NPAs of the previous years** to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.

Question 15

CA Nadar is conducting the statutory audit of RHL Ltd., a non-banking financial company. It has branches in various parts of India. The company with a focus on housing finance, has outstanding non-convertible debentures worth Rs 150 Crores. The company reportedly missed interest payments of INR 15 Crores on its debts because of inadequate liquidity. As a result, RHL Ltd. faced a series of downgrades by rating agencies on its debts over the past two months. Rating was cut to D from A4 implying that the company was in default or expected to be in default soon. What aspects CA Nadar should look into in relation to the activity of mobilization of public deposits (particularly in relation to downgrading of credit facilities) by RHL Ltd?

Answer

Following aspects should be looked in relation to the activity of mobilisation of public deposits (particularly in relation to downgrading of credit facilities):

The **ceiling on quantum of public deposits has been linked to its credit rating** as given by an approved credit rating agency. **Obtain a copy of the credit rating** assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.

In the event of a upgrading/downgrading of credit rating, the auditor should bear in mind that the **NBFC will have to increase/reduce its public deposits** in accordance with the revised credit rating assigned to it within a specified time frame and should ensure that the NBFC has informed about the same to the RBI in writing.

In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or a factor, shall **regularise the excess deposit** as provided hereunder:

- (a) with immediate effect, **stop accepting fresh public deposits** and renewing existing deposits;
- (b) **all existing deposits shall run off to maturity**; and
- (c) **report the position within 15 working days, to the concerned Regional Office of the RBI** where the NBFC is registered.

Provided **no matured public deposit shall be renewed without** the express and voluntary **consent of the depositor**.

Chapter 12

Audit under Fiscal Laws

Unit I – Audit under Direct Tax Laws

Question 1

Mr. A engaged in business as a sole proprietor presented the following information to you for the FY 2020-21. Turnover made during the year ₹ 624 lacs. Goods returned in respect of sales made during FY 2019-20 is ₹ 20 lacs not included in the above. Cash discount allowed to his customers ₹ 1 lac for prompt payment. Special rebate allowed to customer in the nature of trade discount ₹ 5 lacs. Kindly advise him whether he has to get his accounts audited u/s 44AB of the Income Tax Act, 1961.

Answer

Turnover limit for the purpose of Tax Audit: The following points merit consideration as stated in the Guidance note on Tax Audit issued by the Institute of Chartered Accountants of India-

- (i) Price of **goods returned should be deducted** from the figure of turnover even if the return are from the sales made in the earlier years.
- (ii) **Cash discount otherwise than that allowed in a cash memo/sales invoice** is in the nature of a financing charge and is not related to turnover. The same should **not be deducted** from the figure of turnover.
- (iii) **Special rebate** allowed to a customer **can be deducted** from the sales if it is in the nature of trade discount.

Applying the above stated points to the given problem,

1. Total Turnover	624 Lacs
2. Less – (i) Goods Returned	20 Lacs
(ii) Special rebate allowed to customer in the nature of trade discount would be deducted	<u>5 Lacs</u>
Balance	<u>599 Lacs</u>

As the limit for tax audit is ₹ five crores (assuming the aggregate of all amounts received including amount received for sales, turnover or gross receipts during the previous year, in cash, does not exceed five per cent of the said amount and aggregate of all payments made including amount incurred for expenditure, in cash, during the previous year does not exceed five per cent of the said payment), he would be required to get his accounts audited under section 44AB of the Income Tax Act, 1961.

Question 2

Comment with respect to computation of total sales, turnover or gross receipts in business exceeding the prescribed limit under Section 44 AB of Income Tax Act, 1961.

- (i) Discount allowed in the sales invoice
- (ii) Cash discount
- (iii) Price of goods returned related to earlier year

(iv) Sale proceeds of fixed assets.

Answer

Computation of Sales, Turnover or Gross Receipts: In the context of section 44AB of the Income Tax Act, 1961, following considerations are required with regard to computation of sales, turnover or gross receipts in business exceeding the prescribed limit under section 44AB of the Income Tax Act, 1961-

- (i) **Discount allowed in the sales invoice** will reduce the sale price and, therefore, the same can be **deducted** from the turnover.
- (ii) **Cash discount otherwise than that allowed in a cash memo/sales invoice** is in the nature of a financing charge and is not related to turnover. Therefore, should **not be deducted** from the turnover.
- (iii) Price of **goods returned should be deducted** from the turnover even if the returns are from the sales made in the earlier year/s.
- (iv) **Sale proceeds of fixed assets would not form part of turnover** since these are not held for resale.

Question 3

Concession Ltd. is engaged in the business of manufacturing of threads. The company recorded the turnover of ₹ 8.13 crore during the financial year 2020-21 before adjusting the following:

Discount allowed in the Sales Invoice	₹ 8,20,000
Cash discount (other than allowed in Cash memo/ sales invoice)	₹9,20,000
Trade discount	₹2,90,000
Commission on Sales	₹6,00,000
Sales Return (F.Y. 2018-19)	₹1,60,000
Sale of Investment	₹6,60,000

You are required to ascertain the effective turnover to be considered for the prescribed limit of tax audit under the relevant Act and guide the company whether the provisions relating to tax audit applies.

Answer

The provisions relating to tax audit under section 44AB of the Income Tax Act, 1961 applies to every person carrying on business, **if his total sales, turnover or gross receipts in business exceed the prescribed limit of ₹ 1 crore** (Provided that in the case of a person whose aggregate of all amounts received including amount received for sales, turnover or gross receipts during the previous year, in cash, does not exceed five per cent of the said amount and aggregate of all payments made including amount incurred for expenditure, in cash, during the previous year does not exceed five per cent of the said payment, the limit of one crore rupees shall change to five crore rupees) and to a person carrying on a profession, **if his gross receipts from profession exceed the prescribed limit of ₹ 50 lakhs in any previous year**. However, the term "sales", "turnover" or "gross receipts" are not defined in the Act, and therefore the meaning of the aforesaid terms has to be considered for the applicability of the section.

Some of the points for merit consideration in this regard as discussed in the Guidance Note issued by the Institute are given below-

Audit under Fiscal Laws

- (i) **Discount allowed in the sales invoice** will reduce the sale price and, therefore, the same can be **deducted** from the turnover.
- (ii) **Cash discount otherwise than that allowed in a cash memo/sales invoice** is in the nature of a financing charge and is not related to turnover. Therefore, should **not be deducted** from the turnover.
- (iii) **Turnover discount** is normally allowed to a customer if the sales made to him exceed a particular quantity. As per trade practice, it is in the **nature of trade discount and should be deducted** from the figure.
- (iv) **Special rebate allowed to a customer can be deducted** from the sales if it is in the nature of trade discount. If it is in the nature of commission on sales, the same cannot be deducted from the figure of turnover.
- (v) Price of **goods returned should be deducted** from the turnover even if the returns are from the sales made in the earlier year/s.
- (vi) **Sale proceeds of any shares, securities, debentures, etc., held as investment will not form part of turnover.** However, if the shares, securities, debentures etc., are held as stock-in-trade, the sale proceeds thereof will form part of turnover.

In the given case, Concession Ltd. is engaged in manufacturing business. Therefore, the tax audit would be applicable if the turnover exceeds ₹ 5 crores during the financial year 2020-21. The calculation of effective turnover for the prescribed limit purpose, in accordance with abovementioned conditions, is given below:

Recorded turnover during the year	₹ 8,13,00,000
Less: (i) Discount allowed in the Sales Invoice	(₹ 8,20,000)
(ii) Trade discount	(₹ 2,90,000)
(iii) Sales Return	(₹ 1,60,000)
Effective turnover	₹ 8,00,30,000

Conclusion: The expected effective turnover of Concession Ltd. is Rupees Eight Crores and Thirty Thousand only which is over and above the prescribed limit for tax audit under section 44AB of the Income Tax Act, 1961. Thus, the **provisions related to tax audit would be applicable to the company and would therefore be liable for tax audit.**

Question 4

You are doing the tax audit of a Limited Company. After submission of Tax Audit Report, management notices that there was apparent mistake of law and due to this mistake, revised the final accounts. As a tax auditor, company seeks your opinion whether the tax audit can also be revised or not.

Or

State whether a Tax audit report can be revised and if so state those circumstances.

Answer

Revision of Tax Audit Report:

- (i) Normally, the report of the tax auditor **cannot be revised later.**
- (ii) However, **when the accounts are revised in the following circumstances, the tax Auditor may have to revise his Tax audit report also.**
 - (a) **Revision of accounts** of a company after its adoption in the annual general meeting.
 - (b) **Change in law with retrospective effect.**

(c) **Change in interpretation of law** (e.g.) CBDT Circular, Notifications, Judgments, etc.

The Tax Auditor **should state it is a revised Report**, clearly specifying the reasons for such revision with a reference to the earlier report.

Thus, the Tax Audit Report can be changed under the given circumstances.

Question 5

Write a short note on - Method of accounting in Form No. 3CD of Tax Audit.

Answer

Method of accounting in Form No. 3CD of Tax Audit: Clause 13 of Form No. 3CD of the tax audit requires to state method of accounting employed in the previous year. It also requires to state the change in method of accounting vis-à-vis the preceding year. If so, details of change and the effect on the profit or loss are to be stated. Also details of deviation thereof if any, from accounting standards prescribed under section 145 and the effect there of on the profit or loss are stated. **Section 145 provide that method of accounting be either cash or mercantile. Hybrid system is not permitted.**

Question 6

ABC Printing Press, a proprietary concern, made a turnover of above ₹ 1.03 crore for the year ended 31.03.2020. The Management explained its auditor Mr. Z that it undertakes different job work orders from various customers. The raw materials required for each job are dissimilar. It purchases the raw materials as per specification/ requirements of each customer and there is hardly any balance of raw materials remaining in the stock except pending work- in-progress at the year end. Because of variety and complexity of materials, it is impossible to maintain a stock-register. Give your comments.

Answer

Non-maintenance of stock register: The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the **auditor needs to verify the specified job-orders received** and the different raw materials purchased for each job separately. The **use of different papers** (quality, quantity and size) ink, colour etc. may be **examined**. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom. At the same time, he has to report and certify under clause 35(b) and clause 11(b) of Form 3CD read with the Rule 6G(2) of the Income-tax Act, 1961, about the details of stock and account books (including stock register) maintained. He must **verify the closing stock** of raw materials, work-in-progress and finished goods of the concern, at least on the date of its balance sheet. In case the said details are not properly maintained, he has to **specifically mention the same with reasons for non-maintenance of stock register** by the entity.

Question 7

A Co-operative Society having receipts above ₹ 1 crore gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a Chartered Accountant. State with reasons whether such audit report can be furnished as tax audit report under Section 44AB of the Income-tax Act, 1961?

Answer

Furnishing Audit Report of a Co-operative Society: As per Section 44AB read with Explanation to Section 288(2) of the Income Tax Act, 1961, “**accountant**” means a **chartered accountant** within the meaning of the Chartered Accountants Act, 1949, and includes, in relation to any State, any person who by virtue of the provisions of section 141 of the Companies Act, 2013, is entitled to be appointed to act as an auditor of companies registered in that State.

Accordingly, the **person who is not a Chartered Accountant** as mentioned in the question, though is **eligible to act as auditor of Cooperative Society under the Cooperative Society Act, 1912, but is not eligible to carry out tax audit under Section 44AB** of Income Tax Act, 1961.

Hence, **such audit report cannot be furnished** as tax audit report under Section 44AB of the Income-tax Act, 1961.

Question 8

While doing Tax Audit, under section 44AB of the Income Tax Act, 1961, of the accounts of Glue Private Limited for the Assessment Year 2020-21, it was found that during the Financial Year 2019-20, Glue Private Limited had received 9,000 shares, the market value of which was ₹ 90,000 on the date of transfer, at a price of ₹ 45,000 from Stick Private Limited. The Management of Glue Private Limited maintained that the transaction was as per the terms of negotiations and there would be no cause for the Auditor to bring this matter in his Tax Audit Report - Comment.

Answer

Reporting for Receipt of Shares, the Aggregate Fair Market Value of Which Exceeds ₹ 50,000: In this case, Glue Private Ltd. is a company, other than a company in which the public are substantially interested. During the previous year 2019-20, the company received property, being shares, for rupees 45000 as consideration, the fair market value of which is ₹90,000.

A tax auditor **has to furnish the details of shares received** during the previous year, **under clause 28 of Form 3CD**, in case, the **assessee has received any property, being share of a company** not being a company in which public are substantially interested, **without consideration or for inadequate consideration** as referred to in section 56(2) of the Income Tax Act, 1961.

Section 56(2) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company not being a company in which the public is substantially interested,

- (i) without consideration, the **aggregate fair market value of which exceeds ₹ 50,000**, the whole of the aggregate fair market value of such property;
- (ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding ₹ 50,000, the **aggregate fair market value of such property as exceeds such consideration**,

shall be chargeable to income-tax under the head “**Income from other sources**”.

As per the facts of the case, provisions and explanations given above, the income generated by Glue Private Ltd., is rupees 45,000 i.e. in excess of fair market value of shares received (i.e. ₹ 90,000), is lesser than rupees 50,000 as per section 56(2) of the Income Tax Act, 1961. Therefore, the **tax auditor of Glue Private Ltd. is not required to furnish the details of such shares received** under clause 28 of Form 3CD. The **contention of the management** of the company, for

not reporting such receipt of shares, **is in order.**

Question 9

AB Ltd. is a company in which public are not substantially interested. During the previous year 2019-20, the company issued shares to residents of India and provides you the following data related to such issue:

No. of shares issued	1,00,000
Face Value	₹ 10 per share
Fair Market Value (FMV)	₹ 60 per share
Consideration received	₹ 80 per share

The management of the company contends that, it is a normal issue of shares, thus, needs not to be reported. As the tax auditor of AB Ltd., how would you deal with the matter in your tax audit report?

Answer

Reporting for issue of shares for value exceeding fair market value: In this case, AB Ltd. is a company, other than a company in which the public are substantially interested. During the previous year 2019-20, it receives consideration for issue of shares (i.e. ₹ 80 per share) which exceeds the face value (i.e. ₹ 10 per share) and fair market value of the shares (i.e. ₹ 60 per share).

Provisions and Explanations: **A tax auditor has to furnish the details of shares issued** during the previous year, **under clause 29 of Form 3CD, in case, the assessee received any consideration for issue of shares which exceeds the fair market value** of the shares as referred to in section 56(2)(viib) of the Income Tax Act, 1961.

Section 56(2)(viib) provides that where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any **consideration for issue of shares that exceeds the face value of such shares**, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head **“Income from other sources”**.

Since section 56(2)(viib) is applicable to companies in which public is not substantially interested, reporting under this clause is to be done only for corporate assesseees. The **auditor should obtain from the auditee, a list containing the details of shares issued**, if any, by him to any person being a resident and verify the same from the books of accounts and other relevant documents.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by AB Ltd., due to differences in consideration received and fair market value of shares issued, is chargeable to income-tax under the head **“Income from other sources”** as per section 56(2)(viib) of the Income Tax Act, 1961.

Therefore, the **tax auditor of AB Ltd. is required to furnish the details of shares issued** under clause 29 of Form 3CD. The **contention of the management** of the company, behind non-reporting, that it is a normal issue of shares, **is not acceptable.**

Question 10

ABC Pvt. Ltd. and XYZ Pvt. Ltd. are the companies in which public are not substantially interested. During the previous year 2019-20, ABC Pvt. Ltd. received some property, being shares of XYZ Pvt.



Ltd., the details of which are provided below:

No. of Shares:	1,000
Aggregate fair market value of shares:	₹ 75,000
Consideration value:	Nil

The management of the company contends that the shares need not to be furnished in Form No. 3CD. As the tax auditor of ABC Pvt. Ltd., how would you deal with the matter?

Answer

Reporting for Receipt of Shares, the Aggregate Fair Market Value of Which Exceeds ₹ 50,000:

In this case, ABC Pvt. Ltd. is a company, other than a company in which the public are substantially interested. During the previous year 2019-20, the company received property, being shares, for no consideration, the aggregate fair market value of which is ₹ 75,000.

Provisions and Explanations: **A tax auditor has to furnish the details of shares received during the previous year, under clause 28 of Form 3CD, in case, the assessee has received any property, being share of a company not being a company in which public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(x) of the Income Tax Act, 1961.**

Section 56(2)(viiia) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company not being a company in which the public is substantially interested,

- (i) without consideration, the **aggregate fair market value of which exceeds ₹ 50,000**, the whole of the aggregate fair market value of such property;
- (ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding ₹ 50,000, the **aggregate fair market value of such property as exceeds such consideration**,

shall be chargeable to income-tax under the head **“Income from other sources”**.

The fair market value of shares means the value as determined in accordance with the method prescribed in Income Tax Rules, 1962.

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by ABC Pvt. Ltd., being whole of the aggregate fair market value of shares received (i.e. ₹ 75,000), is chargeable to income-tax under the head “Income from other sources” as per section 56(2)(x) of the Income Tax Act, 1961.

Therefore, the tax auditor of ABC Pvt. Ltd. is required to furnish the details of such shares received under clause 28 of Form 3CD. The **contention of the management** of the company, for not reporting such receipt of shares, **is not acceptable**.

Question 11

In the course of your tax audit assignment u/s 44AB of the Income Tax Act, 1961 of Dream Bank Ltd., you have instructed your assistant to find out receipt of capital nature which might not have been credited to Profit & Loss Account and needs to be reported in Para 16(e) of Form 3CD. Your audit assistant seeks your guidance in reporting the same. Specify any four illustrative examples of such receipt.

Answer

Capital Receipts which, if not credited to the profit and loss account, are to be stated under clause 16(e) of Form 3CD:

- (a) **Guidance for reporting capital receipts:** Capital receipts are not generally credited to profit and loss account hence the auditor should take enough care to check out any transaction generating the capital receipts by –
- Enquiring whether the assessee is in **receipt of any amount of capital nature** during the previous year.
 - Going through the financial statements, in particular reserve account, to ascertain whether the assessee has received any such receipts and **credited them directly to reserve account.**
 - Enquiring whether the assessee has **credited such receipts to profit and loss account.**
 - Checking that any such receipts is accounted for in terms of **method of accounting** followed by the assessee.
- (b) **Illustrative examples of capital receipts:** The following is an illustrative list of capital receipts which, if not credited to the profit and loss account, are to be stated under clause 16(e) of Form 3CD-
- (i) **Capital subsidy received in the form of Government grants**, which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For e.g., Capital Investment Subsidy Scheme.
 - (ii) Government **grant in relation to a specific fixed asset** where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.
 - (iii) Compensation for **surrendering certain rights.**
 - (iv) **Profit on sale of fixed assets/investments** to the extent not credited to the profit and loss account.

Question 12

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 ₹ 55 lakhs which is higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Auditor under Section 44AB of Income-tax Act, 1961.

Answer

Reporting for change in the method of valuation of stock: 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.

This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 14 in Form 3CD.

- (a) **Method of valuation** of closing stock employed in the previous year.
- (b) **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 consistently** from year to year. It is also necessary to ensure that method followed for valuation of stock results in correct profits or gain. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made in 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.

Question 13

Write a short note on - Accounting ratios in Form 3CD of Tax Audit.

Answer

Accounting Ratios in Form 3CD of Tax Audit: Details regarding turnover, gross profit, etc., for the previous year and preceding previous year should be provided as follows:

Serial Number	Particulars	Previous year	Preceding Previous year
1.	Total turnover of the assessee		
2.	Gross profit/turnover		
3.	Net profit/turnover		
4.	Stock-in-trade/turnover		
5.	Material consumed/finished goods produced		

The details required to be furnished for principal items of goods traded or manufactured or services rendered. These ratios have to be **calculated only for assesseees who are engaged in manufacturing or trading activities**. This clause is **not applicable to** assesseees carrying on **profession**. Moreover, the ratios have to be given for the business as a whole and **need not be given product wise**.

Question 14

Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment.

Answer

Form 3CD: The audit under section 44AB of the Income Tax Act 1961 requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are **true and correct**. It is the **primary responsibility of the assessee to prepare the information in form 3CD**. The auditor has to examine whether the information given is true and correct. The

form 3CD is not a report of Tax Auditor. The report is in the form of 3CA or 3CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3CD is true and correct then he can give unqualified report in form 3CA or 3CB saying "in my opinion and to the best of my information and according to the explanations given to me and considering the materiality the particulars given in form 3CD are true and correct." But in the given case the tax auditor has found that the form 3CD contains the incomplete, misleading and false information.

Disallowance under **section 40A(3)** is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds ₹ 10,000. However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted.

Under clause 21(d)(A) of Form 3CD, the tax auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clause.

Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD. Therefore, **Mr. R has to report the payments inadmissible under section 40A(3) under clause 21(d)(A) of Form 3CD.**

Question 15

While conducting the tax audit of A & Co. you observed that it made an escalation claim to one of its customers but which was not accounted as income. What is your reporting responsibility?

Answer

Clause 16(c) of Form 3CD: A tax auditor has to report under clause 16(c) of Form 3CD on any **escalation claim accepted** during the previous year **and not credited to the profit and loss account** under clause 16(c) of Form 3CD.

The escalation claim accepted during the year would normally mean "accepted during the relevant previous year". If such amount are not credited to Profit and Loss Account the fact should be reported. The system of accounting followed in respect of this particular item may also be brought out in appropriate cases. If the assessee is following cash basis of accounting with reference to this item, it should be clearly brought out since acceptance of claims during the relevant previous year without actual receipt has no significance in cases where cash method of accounting is followed.

Escalation claims should normally arise pursuant to a contract (including contracts entered into in earlier years), if so permitted by the contract. Only those claims to which the **other party has signified unconditional acceptance could constitute accepted claims**. Mere making claims by the assessee or **claims under negotiations cannot constitute accepted claims**. After ascertaining the relevant factors as outlined above, a decision whether to report or not, can be taken.

Question 16

As a tax auditor how would you deal and report the following:

- (i) An assessee has borrowed ₹ 50 lakhs from various persons. Some of them by way of cash and some of them by way of Account payee cheque/Draft.
- (ii) An assessee has paid Rent to his brother ₹ 2,50,000/- and paid interest to his sister ₹ 4,00,000/-.

Answer

- (i) **Borrowal of ₹ 50 Lakhs:** As per Clause 31 of Form 3CD the particulars of each loan or deposit taken or accepted during the previous year have to be stated in the Tax Audit Report.

Further, Clause 31(a) requires reporting in case **if the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft**. In addition, as per Clause 31(c) the tax auditor has to state whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents. Furthermore, the tax auditor has the responsibility to verify the compliance with the **provisions of section 269SS and 269T** of the Income Tax Act.

Therefore, in the present case, where the assessee has borrowed ₹ 50 Lakhs by way of cash and some of them by way of Account payee cheque/ draft, needs to be verified and to be **reported in compliance with Clause 31 of Form 3CD**.

- (ii) **Payment of Rent and Interest:** A tax auditor has to report under Clause 23 of Form 3CD which deals with the **particulars of payments made to persons specified under Section 40A(2)(b)** of the Income Tax Act, 1961. Where the assessee is an individual, the specified persons include any relative of the assessee (i.e. Husband, Wife, Brother, Sister or any other Lineal Ascendant or Descendant).

In the present case, an assessee has paid rent to his brother ₹ 2,50,000 and interest to his sister of ₹ 4,00,000 which may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or unreasonable having regard to:

- (1) the **fair market value** of the goods, services or facilities for which the payment is made; or
- (2) for the **legitimate needs** of business or profession of the assessee; or
- (3) the **benefit derived** by or accruing to the assessee from such expenditure. Hence this fact needs to be reported in the Tax Audit Report accordingly.

Question 17

As an auditor of a partnership firm under section 44AB of the Income Tax Act, 1961, how would you report on the following:

- (i) Capital expenditure incurred for scientific research assets
- (ii) Expenditure incurred at clubs.

Answer

- (i) **Capital Expenditure incurred for Scientific Research Assets:** Expenditure on Scientific

Audit under Fiscal Laws

Research (capital as well as revenue) covered under section 35 of the Income- Tax Act, 1961, **is to be reported by a tax auditor under clause 19** of Form 3CD. The tax auditor is required to report the following:

- (a) **amount debited to the profit and loss account**, and
 - (b) **amounts admissible as per** the provisions of the **Income-tax Act, 1961** and also fulfils the conditions, if any specified under the relevant provisions of Income-tax Act, 1961 or Income-tax Rules, 1962 or any other guidelines, circular, etc., issued in this behalf.
- (ii) Payment to Club:** As per **Clause 21(a) of Form 3CD**, the amount of expenditure incurred at clubs by the assessee during the year being entrance fees and subscriptions, and being cost for club services and facilities used should be indicated.

The **payments made may be in respect of directors and other employees** in case of companies, and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. The **tax auditor is required to furnish the details of amounts debited** to the profit and loss account, being in the nature of capital, personal, advertisement expenditure etc.

Question 18

While writing the audit program for tax audit in respect of A Ltd., you wish to include possible instances of capital receipt if not credited to Profit & Loss Account which needs to be reported under clause 16(e) of form 3CD. Please elucidate possible instances.

Answer

The following is an **illustrative list of capital receipts** which, if not credited to the profit and loss account, are to be stated under clause 16(e) of Form 3CD-

- (a) **Capital subsidy received in the form of Government grants**, which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For e.g., Capital Investment Subsidy Scheme.
- (b) Government grant in relation to a **specific fixed asset** where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.
- (c) Compensation for **surrendering certain rights**.
- (d) **Profit on sale of fixed assets**/investments to the extent not credited to the profit and loss account.

Question 19

XYZ Ltd. pays ₹ 90000 for its 6 employees to a Hotel as boarding and lodging expenses of such employees for a conference. The Company pays the amount in cash to the Hotel. The Hotel gives 6 bills each amounting to ₹ 15000. The Company contends that each bill is within the limit, so there is no violation of the provisions of the Income Tax Act, 1961. As the tax auditor, how would you deal with the matter in your tax audit report for the Assessment Year 2020-21?

Answer

Reporting for Payment in Cash above ₹ 10,000: As per section 44AB of the Income Tax Act, 1961, the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are **true and correct**. It is the **primary responsibility of the assessee to prepare the information in form 3CD**.

Disallowance under **section 40A(3)** of the Income Tax Act, 1961 is attracted if the assessee incurs any expenses in respect of which payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft, exceeds ₹ 10,000. However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted.

In the given case, the tax auditor found that a hotel issued 6 bills to XYZ Ltd. each amounting to ₹ 15,000 for boarding & lodging expenses of 6 employees. XYZ Ltd. in aggregate has paid ₹ 90,000 to the hotel in cash. Consequently, no expenditure shall be allowed for deduction as per the provisions of section 40A(3).

Furthermore, under clause 21(d)(A) of Form 3CD, the **tax auditor has to scrutinize on the basis of the examination of books of account** and other relevant documents/evidence, whether the expenditure covered under section 40A(3) read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clause. Contention of the company that each bill is within the limit is not tenable since aggregate of payments need to be considered.

Therefore, the **payments made by the XYZ Ltd. are inadmissible under section 40A(3)** of the Income Tax Act, 1961 and hence, **needs to be reported under clause 21(d)(A) of Form 3CD**.

Question 20

Mr. Bhupesh, is a renowned criminal lawyer, practising in Meerut. During the previous year, he collected GST of ₹ 25 lakhs but utilized it for his personal use. The Commissioner of Indirect Taxes issued a show cause notice to him as to why the tax, collected by him, is not deposited to the government account. He appeared before the Commissioner and stated his inability to pay the sum due to financial crisis. The proceedings are still pending before the Commissioner.

Mr. Bhupesh instructed his tax auditor not to disclose his GST registration details, while filling particulars to be furnished in Form No. 3CD, believing that the income tax department might trace his scrutiny proceedings details pending before Commissioner of Central Excise which would bring disrepute to his profession. As a tax auditor, how would you report?

Answer

Reporting Requirement Under Clause (4) of Form 3CD: Mr. Bhupesh has defaulted in payment of GST for the previous year. Consequently, the Commissioner of Indirect Taxes issued a show cause notice for such non-payment of tax. The arguments are still going on between the department and assessee. He also restrained his tax auditor from disclosing GST registration details in tax audit report.

Provisions and Explanations: A tax auditor is required to **report under Clause (4) of Form 3CD, which requires him to mention the registration number or any other identification number**, if any, allotted, in case the assessee is liable to pay **indirect taxes** like GST, excise duty, sales tax, customs duty, etc.

Part A of Form No. 3CD generally requires the auditor to give the factual details of the assessee.

Thus, the **auditor is primarily required to furnish the details of registration numbers** as provided to him by the assessee.

The reporting is however, to be done in the manner or format specified by the e-filing utility in this context. The information may be obtained and maintained in the following format:-

Sr.No	Relevant Indirect tax Law which requires registration	Place of Business / profession / service unit for which registration is in place / or has been applied for:-	Registration/ Identification number
1	2	3	4

Furthermore, the auditor has to keep in mind the provisions of **Standard on Auditing 580 “Written Representation”**. In case the auditor prima facie is of the opinion that any indirect tax laws is applicable on the business or profession of the assessee but the assessee is not registered under the said law, the auditor should report the same appropriately.

Conclusion: Therefore, the tax auditor of Mr. Bhupesh is required to furnish GST registration number under Clause (4) of the Form 3CD. Thus, **contention of Mr. Bhupesh not to disclose the service tax details is not tenable.**

Question 21

BB Ltd., a non-resident company, is engaged in the business of extraction of mineral oils, having turnover of ₹ 20 lakhs during the financial year 2019-20. The company claims that its profits and gains chargeable to tax under the head "Profits and gains of business or profession" is lower than the deemed income chargeable under section 44BB of the Income Tax Act, 1961. Therefore, it decided to get its accounts audited under section 44AB of the Income Tax Act, 1961. As a tax auditor, how would you report?

Answer

Reporting Requirement Under Clause (8) and (12) of Form 3CD: BB Ltd., is a non resident company which is engaged in the business of extraction of mineral oils, hence, its income is chargeable in accordance with the provisions of section 44BB of the Income Tax Act, 1961. But it has turnover of ₹ 20 lakhs during the financial year 2019-20. Therefore, the company does not need to get its accounts audited under section 44AB of the Income Tax Act, 1961 as it is below the prescribed limit applicable for auditing of accounts. However, company is claiming lower income in comparison to deemed income under section 44BB of the said Act, thus, the company needs to get its accounts audited.

Provisions and Explanations: **Under Clause (8) of Form 3CD**, the tax auditor is required to mention the relevant clause of section 44AB under which the audit has been conducted. In case the assessee is carrying on business and his total sales, turnover or gross receipts as the case may be, exceeds one crore in the relevant previous year, the auditor is required to mention clause (a) under this head. If the assessee is carrying on profession and his gross receipts exceed fifty lakh rupees in the relevant previous year, the auditor is required to mention clause (b) under this head. Likewise, if the audit under section 44AB is being conducted by virtue of provisions of section 44AE, 44BB and 44BBB, the auditor is required to mention clause (c). For audit being conducted by virtue of provisions of section 44ADA, clause (d) is to be mentioned under this head. For audit being conducted by virtue of provisions of section 44AD, clause (e) is to be mentioned under this head.

Further, as per Clause (12) of Form 3CD, if the profit and loss account of the assessee **includes any profits and gains assessable on presumptive basis, the tax auditor has to indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB, Chapter XII-G, First Schedule or any other relevant section).**

Conclusion: As per the facts of the case, provisions and explanations given above, the **tax auditor of BB Ltd. is required to mention clause (c) of section 44AB, under clause (8) of Form no. 3CD.**

In addition to above, the tax auditor has to indicate, under Clause (12) of Form No. 3CD, the amount of profits and gains assessable on presumptive basis under section 44BB of the Income Tax Act i.e. the amount of profits and gains credited/debited to the Profit & Loss Account.

Question 22

M/s. N.S. Enterprises, a manufacturing concern, sold a house property in Mumbai for a consideration of ₹ 48 lakh, to Mr. Gunaj on 1.8.2019. M/s. N. S. Enterprises had purchased the house property in the year 2017 for ₹ 40 lakh. The stamp duty value on the date of transfer, i.e., 1.8.2019, is ₹ 85 lakh for the house property. As a tax auditor, how would you report?

Answer

Reporting Requirement Under Clause (17) of Form 3CD: In this case, M/s N.S. Enterprises is a manufacturing concern and sold the house property in Mumbai for a consideration of ₹ 48 Lakh which is less than value assessed by Government i.e. Stamp Duty value of ₹ 85 Lakh.

Provisions and Explanations: As per Clause 17 of Form 3CD, the **tax auditor is required to furnish detailed information in case if any land or building or both is transferred** during the previous year **for a consideration less than value adopted or assessed** or assessable by any authority of a State Government referred to in section 43CA or 50C, as under:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

The auditor should obtain a list of all properties transferred by the assessee during the previous year. He may also verify the same from the statement of profit and loss or balance sheet, as the case may be. Further, the **auditor has to furnish the amount of consideration received or accrued**, during the relevant previous year of audit, in respect of land/building transferred during the year as disclosed in the books of account of the assessee.

For reporting the value adopted or assessed or assessable, the auditor should obtain from the assessee a copy of the registered sale deed in case, the property is registered. In case the property is not registered, the auditor may verify relevant documents from relevant authorities or obtain third party expert like lawyer, solicitor representation to satisfy the compliance of section 43CA/section 50C of the Act. In exceptional cases where the auditor is not able to obtain relevant documents, he may state the same through an observation in his report 3CA/CB.

Conclusion: As already discussed in fact of the cases, M/s. N.S. Enterprises, has sold the house property to Mr. Gunaj which is less than stamp duty value. **Hence, tax auditor is required to report on the same under Clause 17 of Form 3CD.**

Question 23

SL Pvt. Ltd. is a company engaged in the production of wool. Along with its production business, the company is also engaged in buying and selling of securities with the expectation of a favourable price change. It reports the following data for the current financial year:

S. No.	Particulars	Amount (in ₹)
1	Paid up Share Capital	100 lakhs
2	Capital Reserve	33 lakhs
3	Capital Redemption Reserve	45 lakhs
4	Revaluation Reserve	32 lakhs
5	Speculation Loss on account of Purchase and Sales of Securities	12 lakhs

As a tax auditor, how would you report?

Answer

Reporting Requirement Under Clause (32)(e) of Form 3CD: SL Pvt. Ltd. is engaged in production business and side by side dealing in buying and selling of securities with the intention of speculation. During the current financial year, the company has made Speculation Loss of ₹ 12 lakhs.

Provisions and Explanations: A tax auditor has to furnish the details of speculation loss incurred during the previous year, under Clause 32(e) of Form 3CD, regarding **whether the company is deemed to be carrying on a speculation business as referred in explanation to section 73.**

The Explanation to section 73 provides that where any part of the business of a company (**other than a company** whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources" or a company **the principal business of which is the business of trading in shares or banking or the granting of loans and advances**) consists in the purchase and sale of shares of other companies, **such company shall**, for the purposes of this section, **be deemed to be carrying on a speculation business** to the extent to which the business consists of the purchase and sale of such shares.

Conclusion: Therefore, the **tax auditor of SL Pvt. Ltd. is required to furnish the details** under Clause 32(e) of Form 3CD with respect to the speculation loss of ₹ 12 lakhs made during the year.

Question 24

Saurabh International Ltd. (SIL) was engaged in providing certain services on which it did not pay any GST. As per SIL, said services were not liable to GST. However, Department issued a show cause notice to SIL demanding GST alongwith interest worth ₹ 5,45,000 on the same and such demand was also confirmed. An appeal was filed to the Commissioner of Central Excise (Appeals) which passed an order which upheld the demand on SIL. SIL, being aggrieved by the order of the Commissioner of Central Excise (Appeals), decided to file an appeal to the CESTAT against such order. SIL has also requested the tax auditor not to report as those services were not liable for GST and it has also filed an appeal for the same. As a tax auditor, how would you report?

Answer

Reporting Requirement under Clause (41) of Form 3CD: In the instant case, Saurabh

Audit under Fiscal Laws

International Ltd. (SIL) is engaged in providing certain services on which it did not paid any GST. Therefore, Department issued a show cause notice and demand for GST along with interest thereon. SIL has also filed an appeal mentioning that said services are not liable to GST, but Central Excise (Appeals) has passed an order confirming the demand and SIL being aggrieved by the order of Commissioner of Central Excise (Appeals) decided to file an appeal against the same. SIL also requested the tax auditor not to report on the same as the concerned services were not liable for any GST and they have also decided to file an appeal to CESTAT against the order of Commissioner of Central Excise (Appeals).

Provisions and Explanations: As per Clause 41 of Form 3CD, the **tax auditor should furnish the details of demand raised or refund issued** during the previous year **under any tax laws other than Income Tax Act, 1961** and Wealth tax Act, 1957 along with details of relevant proceedings.

Therefore, the tax auditor should obtain a copy of all the demand/ refund orders issued by the governmental authorities during the previous year under any tax laws other than Income Tax Act and Wealth Tax Act alongwith its proceeding. It may be noted that **even though the demand/refund order** is issued during previous year, it may **pertain to a period other than the relevant previous year. In such cases also, reporting has to be done under this clause.**

Conclusion: In the instant case, reporting of the demand raised by Department and proceeding relating to it including appeal filed by SIL and decision thereon is required to be made by tax auditor as per Clause 41 of Form 3CD. **Hence request of SIL, not to report on the same is not acceptable.**

Question 25

Ploy Ltd., engaged in the leasing of goods carriage, appointed you as the tax auditor for the financial year 2019-20. How would you deal with the following payments relating to the leasing transactions in your tax audit report:

- (i) Payments of 6 invoices of ₹ 5,000 each made in cash to Mr. X on 4th July, 2019.
- (ii) Payments of 2 invoices of ₹ 18,000 each made in cash to Mr. Y on 5th July, 2019 and 6th July, 2019 respectively.
- (iii) Payment of ₹ 40,000 made in cash to Mr. Z on 7th July, 2019 against an invoice for expenses booked in 2018-19.

Answer

Reporting of Payments Exceeding ₹ 35,000 in Cash: Disallowance under **section 40A(3)** of the Income Tax Act, 1961 is attracted if the assessee incurs any expenses in respect of which payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft, **exceeds ₹ 10,000. However, in case of payment made for plying, hiring or leasing of goods carriage, limit is ₹ 35,000** instead of ₹ 10,000.

Further, as per section 40A(3A) of the Income Tax Act, 1961, where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments

made to a person in a day, exceeds ₹ 10,000 (₹ 35,000 in case of plying, hiring or leasing of goods carriages).

However, exemption is provided under Rule 6DD having regard to nature and extent of banking facilities available and other relevant factors.

Subsequently, under clause 21(d)(A) and 21(d)(B) of Form 3CD, the tax auditor has to **scrutinize on the basis of the examination of books of account** and other relevant documents/evidence, whether the expenditure covered under section 40A(3) and 40A(3A) respectively read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clauses.

Therefore, as per the provisions and explanations discussed above, the given cases are dealt as under-

- (i) **Payments of 6 invoices** of ₹ 5,000 each aggregating ₹ 30,000 made in cash on 4th July, 2019 **need not be reported** as the aggregate of payments do not exceed ₹ 35,000.
- (ii) **Payments of 2 invoices** of ₹ 18,000 each made in cash on 5th July, 2019 and 6th July, 2019 respectively aggregating ₹ 36,000 **need not be reported** as the payment do not exceed ₹ 35,000 in a day.
- (iii) **Payment of ₹ 40,000** made in cash against an invoice for expenses booked in 2018- 19 is likely to be deemed to be the profits and gains of business or profession under section 40A(3A) of the Income Tax Act, 1961. Thus, the details of such amount **needs to be furnished under clause 21(d)(B) of Form 3CD.**

Question 26

Beam Ltd., having principal place of business in Gujarat, is engaged in the generation, transmission, distribution and supply of electricity throughout the India. The management of the company came to know that the provisions related to maintenance of cost records and cost audit are applicable to the company. The company, therefore, appointed a cost auditor for the financial year 2019-20.

The cost auditor reported certain disqualifications in Form CRA-3 of the cost audit report to which the management of the company disagreed.

The management of Beam Ltd. ingeniously instructed its tax auditor not to reveal any of the disqualifications related to the cost audit while filling particulars to be furnished in Form No. 3CD contending that the disqualifications are not relevant and there is no correlation between tax audit and cost audit as well.

As a tax auditor, how would you deal with the matter?

Answer

Reporting Requirement for Disqualifications in Cost Audit Report: A tax auditor is required to ascertain under Clause (37) of Form 3CD whether cost audit was carried out and if yes, provide the details of disqualification or disagreement on any matter/item/value/quantity as may be reported/identified by the cost auditor.

The tax auditor **should obtain the copy of cost audit from the assessee.** Even though the tax auditor is not required to make any detailed study of such report, he has to take note of the details of disqualification or disagreement on any matter/item/value/quantity as may be

reported/identified by the cost auditor. The tax auditor need not express any opinion in a case where such audit has been ordered but the same has not been carried out.

In the given case, the cost auditor of Beam Ltd. has reported certain disqualifications in Form CRA-3 of the cost audit report.

Therefore, the **tax auditor of Beam Ltd. is required to provide the details of disqualifications reported by the cost auditor** under Clause (37) of the Form 3CD. Thus, the **contention of the management of Beam Ltd.** not to reveal any of the disqualifications related to the cost audit on the belief that there is no correlation between tax audit and cost audit **is not acceptable**.

Question 27

Mr. PK is conducting the Tax audit under section 44 AB of the Income Tax Act, 1961 of MG Ltd. for the year ended 31st March 2020. There is a difference of opinion between Mr. PK and the Management in respect of certain information to be furnished in Form No. 3CD. As a tax auditor, Mr. PK has to report whether the statement of particulars in Form 3CD are true and correct and the same is to be annexed to the report in Form No. 3CA. Advise on the matters to be considered by Mr. PK while furnishing the particulars in Form No. 3CD.

Answer

The statement of particulars given in Form No. 3CD as annexure to the audit report contains forty-one clauses. The tax auditor has to report whether the particulars are true and correct. This Form is a statement of particulars required to be furnished under section 44AB. The same is to be annexed to the reports in Forms No. 3CA and 3CB in respect of a person who carries on business or profession and whose accounts have been audited under any other law and in respect of person who carries on business or profession but who is not required by or under any other law to get his accounts audited respectively.

While furnishing the particulars in Form No. 3CD it would be advisable for the tax auditor to consider the following:

- (i) If a particular item of income/expenditure is **covered in more than one of the specified clauses** in the statement of particulars, care should be taken to make a **suitable cross reference** to such items at the appropriate places.
- (ii) If there is any difference in the opinion of the tax auditor and that of the assessee in respect of any information furnished in Form No. 3CD, the **tax auditor should state both the view points** and also the relevant information in order to enable the tax authority to take a decision in the matter.
- (iii) If any particular clause in Form No. 3CD is not applicable, he should state that the **same is not applicable**.
- (iv) In computing the **allowance or disallowance, he should keep in view the law applicable** in the relevant year, even though the form of audit report may not have been amended to bring it in conformity with the amended law.
- (v) In case the prescribed particulars are given in part or piecemeal to the tax auditor or relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the **auditor should not withhold the entire audit report**. In such a case, he can **qualify his report** on matters in respect of which information is not furnished

to him. In the absence of relevant information, the tax auditor would have no option but to state in his report that the relevant information has not been furnished by the assessee.

- (vi) The information in Form No. 3CD should be **based on the books of accounts, records, documents, information and explanations** made available to the tax auditor for his examination.
- (vii) In case the auditor relies on a **judicial pronouncement**, he may mention the fact as his observations in clause (3) of Form No. 3CA or clause (5) provided in Form No. 3CB, as the case may be.

Question 28

Draft an audit programme for conducting the audit of a Public Trust registered under section 12A of the Income-tax Act, 1961.

Answer

An auditor should conduct routine checking during the course of audit of a public trust, in the following manner:

- (i) Check the **books of account and other records** having regard to the system of accounting and internal control;
- (ii) Vouch the transactions of the trust to satisfy that:
- the **transaction falls within the ambit of the trust** the transaction is properly authorized by the trustees or other delegated authority as may be permissible in law;
 - all **incomes due** to the trust have been **properly accounted for** on the basis of the system of accounting followed by the trust;
 - all **expenses and outgoings** appertaining to the trust have been **recorded** on the basis of the system of accounting followed by the trust;
 - amounts shown as applied towards the **object of the trust** are covered by the objects of trust as specified in the document governing the trust.
- (iii) **Obtain trial balance** on the closing date duly certified by the trustee;
- (iv) **Obtain Balance Sheet and Profit & Loss Account** of the trust authenticated by the trustees and check the same with the trial balance with which they should agree.

Question 29

You are doing Tax Audit of Private Limited Company for the financial year ending 31st March, 2019. During audit, you notice that the company is not regular in deposit of VAT/GST and there remains pendency every year. The details of VAT/GST payable are:

- (i) GST payable as on 31/03/2019 of FY 2018-19 was ₹ 200 Lakh and out of which ₹ 100 Lakh was paid on 15/09/2019 and ₹ 50 Lakh on 30/03/2020 and balance of ₹ 50 Lakh paid on 16/09/2020.
- (ii) GST payable of current financial year 2019-20 was ₹ 100 lakh and out of this, ₹ 40 Lakh was paid on 25/05/2019 and balance of ₹ 60 Lakh remained unpaid till the due date of return.

The date of Tax Audit report and due date of return was 30th September.

Now as a Tax Auditor, how/where the said transaction will be reflected in Tax Audit Report under Section 43B(a)?

Answer

Reporting in Tax Audit Report: Any amount of GST/Tax payable on the last day of previous year (opening balance) as well as on the last day of current year has to be reported in Tax Audit Report under clause 26(A) and 26(B) in reference of section 43B.

Clause 26 (A) dealt GST/VAT payable on the pre-existed of the first day of the previous year but was not allowed in the assessment of any preceding previous year and was either paid {clause 26(A) (a)}/ or/ and/ not paid during the previous year {clause 26(A)(b)}

The details will be as under in regard to opening balances:

Liability Pre-existed on the previous year.

Sr. No.	Section	Nature of Liability	Outstanding Opening balance not allowed in previous year	Amount paid/set-off during the year	Amount written back to P&L Account	Amount unpaid at the end of the year
01	43B(a)	VAT/GST	100 lakh	50 lakh	0	50 lakh

It has been assumed that 50 lakh was allowed in last year as it was paid before the due date of return.

Liability incurred during the previous year

Sr. No.	Section	Nature of Liability	Amount incurred in previous year but remaining outstanding on last day of previous year.	Amount paid/set-off before the due date of filing return/date upto which reported in the tax audit report, whichever is earlier	Amount Unpaid on the due of filing of return/date upto which reported in the tax audit report, whichever is earlier
01	43B(a)	VAT/GST	100 lakh	40 lakh	60 lakh

Question 30

A is the proprietor of a firm M/s ABC & Co. The firm is expecting a turnover of ₹ 900 lakhs during the financial year ending 31/03/2021. The firm sold land and building during the year for a consideration of ₹ 14 lakhs, whose value for stamp duty purposes was ₹ 16 lakhs. As the Tax Auditor of the said firm, is the above required to be reported? If yes, how will you report the same?

Answer

Reporting Requirement Under Clause (17) & (29B) of Form 3CD: As per Clause 17 of Form 3CD, the tax auditor is required to furnish detailed information in case if any land or building or both is transferred during the previous year for a consideration less than value adopted or assessed or assessable by any authority of a State Government referred to in section 43CA or 50C, as under:

Details of property	Consideration received or accrued	Value adopted or assessed or assessable

The auditor should **obtain a list of all properties transferred by the assessee** during the previous year. He may also verify the same from the statement of profit and loss or balance sheet, as the case may be. Further, the auditor has to **furnish the amount of consideration** received or accrued, during the relevant previous year of audit, in respect of land/building transferred during the year as disclosed in the books of account of the assessee.

For reporting the value adopted or assessed or assessable, the auditor should **obtain from the assessee a copy of the registered sale deed** in case, the property is registered. In case the property is not registered, the auditor may verify relevant documents from relevant authorities or **obtain third party expert** like lawyer, solicitor representation to satisfy the compliance of section 43CA / section 50C of the Act. In exceptional cases where the auditor is not able to obtain relevant documents, he may state the same through an observation in his report 3CA/CB.

In addition, as per clause 29(B) (w.e.f. assessment year 2019-20), in case of an immovable property, where the stamp duty value exceeds the consideration by less than the higher of (i) rupees 50,000 or (ii) 10% of the consideration, the difference is not chargeable to tax. Therefore, for **any immovable property, where the stamp duty value is up to 110% of the sale consideration, no addition can be made under section 56(2)(x).**

In the given case, M/s. ABC & Co., has sold land and building during the year for a consideration of rupees 14 lakhs which is less than stamp duty value i.e. rupees 16 lakhs. Further, it is also more than the higher of, 10% of consideration 14 lakhs i.e. 1,40,000 rupees or 50,000 rupees. Hence, tax auditor is required to report on the same under Clause 17 and clause 29(B) of Form 3CD.

Question 31

How will you verify the income & expenditure of earlier years credited/debited in the current year for reporting under clause 27(b) of Form 3CD while carrying out Tax Audit u/s 44AB of the Income Tax Act, 1961?

Answer

Verification of Expenditure/Income of Earlier Years Debited/ Credited in Current Year:

- Ask the assessee to **furnish a schedule indicating particulars** of expenditure/ income of any earlier year debited/credited to the Profit & Loss account of the relevant previous year.
- Verify various expenses account to see whether **any expenditure pertaining to any earlier year has been debited** to the profit and loss account. For example, an assessee might have paid some certification fee etc., for four years in the year under audit. In that case payment of expenses for previous three years would be **prior period payment**.
- Also see that all such items are **properly disclosed**.
- Check while conducting the routine audit, that there is **no expenditure/ income relating to earlier years that has not been mentioned** in the particulars furnished by the assessee.
- In case of **cash system** of accounting, there will be **no amount to be disclosed** under this head.

Question 32

V Pvt Ltd is engaged in the business of providing corporate/professional training programs. It has an annual turnover of INR 69 crores. The company is subject to tax audit for which the work has been started by the tax auditor. For the financial year ending 31 March 2021, the company applied for GST registration for 2 new locations for which registration certificates have not yet been received by the company. However, the registration number is available on the portal of relevant authority which can be verified by checking the details of the company. In this case what should be the audit procedures to verify this registration number?

Answer

The tax auditor should **verify the registration number for the locations for which registration certificates have not been received from online portal** of the relevant authority. The auditor should also ensure that the details furnished while checking the registration number pertains to the company only. If the company has filed any returns for these locations, the auditor should enquire for the same from the management and should **check those returns to verify the correctness of the registration numbers**. In addition, the auditor should **also obtain specific representation** in respect of this point from the management.

Question 33

An assessee has paid Rent to his brother ₹ 2,50,000/- and paid interest to his sister ₹ 4,00,000. State the reporting requirements in the Tax Audit Report.

Answer

Payment of Rent and Interest: A tax auditor has to report under Clause 23 of Form 3CD which deals with the **particulars of payments made to persons specified under Section 40A(2)(b) of the Income Tax Act, 1961**. Where the assessee is an individual, the specified persons include any relative of the assessee (**i.e. Husband, Wife, Brother, Sister or any other Lineal Ascendant or Descendant**).

In the present case, an assessee has paid rent to his brother ₹ 2,50,000 and interest to his sister of ₹ 4,00,000 which may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or unreasonable having regard to:

- (1) the **fair market value** of the goods, services or facilities for which the payment is made; or
- (2) for the **legitimate needs** of business or profession of the assessee; or
- (3) the **benefit derived** by or accruing to the assessee from such expenditure. Hence this fact needs to be reported in the Tax Audit Report accordingly.

Question 34

M/s PQRS & Associates is appointed for conducting tax audit as per Income Tax Act, 1961 of QW Ltd., a cotton textile company. The Company had incurred ₹ 6 lac towards advertisement expenditure on a brochure/ pamphlet published by a political party in Pune. Advise the auditor whether such expenditure should be included in the tax audit report or not.

Answer

Expenses on Advertisement in the Media of a Political Party: In the given situation, M/s PQRS & Associates is appointed for conducting tax audit as per Income Tax Act, 1961 of QW Ltd., a cotton textile company. The Company had incurred ₹ 6 lac towards advertisement expenditure on a brochure/ pamphlet published by a political party.

As per Clause 21(a) of Form 3CD, the **auditor is required to furnish the details of amounts debited to the Profit and Loss Account, being in the nature of advertisement expenditure in any souvenir, brochure, tract, pamphlet or the like published by a political party** in his tax audit report.

Therefore, advertisement expenditure of ₹ 6 lac on brochure/pamphlet published by a political party **shall be reported in the tax audit report** as per Clause 21 (a) of Form 3CD.

Unit II – Audit under Indirect Tax Laws

Question 35

Briefly discuss the provisions given under section 66 regarding Special Audit required under CGST Act.

Answer

Availing the services of experts is an age old practice of due process of law. These experts have done yeoman service to the process of delivering justice. One such facility extended by the Act is in Section 66 where an officer not below the rank of Assistant Commissioner, duly approved, may **avail the services of a Chartered Accountant or Cost Accountant to conduct a detailed examination of specific areas of operations of a registered person.** Availing the services of the expert be it a Chartered Accountant or Cost Accountant is permitted by this section only when the officer considering the nature & complexity of the business and in the interest of revenue is of the opinion that:

- **Value has not been correctly declared; or**
- **Credit availed is not within the normal limits.**

It would be interesting to know how these 'subjective' conclusions will be drawn and how the proper officers determines what is the normal limit of input credit availed.

Circumstances for Notice for Special Audit: An Assistant Commissioner who nurses an opinion on the above two aspects, after commencement and before completion of any scrutiny, enquiry, investigation or any other proceedings under the Act, may direct a registered person to get his books of accounts audited by an expert. Such direction is to be issued in accordance with the provision of Rule 102 (1) FORM GST ADT-03

The **Assistant Commissioner needs to obtain prior permission of the Commissioner** to issue such direction to the taxable person.

Identifying the expert is not left to the registered person whose audit is to be conducted but the expert is to be nominated by the Commissioner.

Question 36

Vijay Maniyar & Associates, a firm of Chartered Accountants, is of the view that under GST law, audit can only be undertaken by the Departmental officers and there is no scope of audit under said law for the Chartered Accountants. You are required to advise Vijay Maniyar & Associates on the same.

Answer

Types of Audit under GST Law by Chartered Accountants: Contention of Vijay Maniyar & Associates, a firm of Chartered Accountants is not correct. GST envisages two types of Audit by Chartered Accountants i.e.

- (1) **Audit of accounts** [Section 35(5) read alongwith section 44(2) and rule 80]
- (2) **Special Audit** wherein the registered person can be directed to get his records including books of account examined and audited by a chartered accountant or a cost accountant during any stage of scrutiny, inquiry, investigation or any other proceedings; depending upon the complexity of the case. [Section 66 and rule 102]

Audit of Accounts [Section 35(5) read alongwith section 44(2) and rule 80]

As per sub-section 5 of section 35 read alongwith section 44(2) and rule 80 of the CGST Rules, 2017 stipulates as follows:

<p>Every registered person must get his accounts audited by a Chartered Accountant or a Cost Accountant if his aggregate turnover during a FY exceeds ₹ 5 crores.</p>	<p>Such registered person is required to furnish electronically through the common portal alongwith Annual Return a copy of:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Audited annual accounts <input type="checkbox"/> A Reconciliation Statement, duly certified, in prescribed FORM GSTR-9C.
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Reconciliation Statement will **reconcile the value of supplies** declared in the return furnished for the financial year with the audited annual financial statement and such other particulars, as may be prescribed.

Special Audit under section 66: Availing the services of experts is an age old practice of due process of law. These experts have done yeoman service to the process of delivering justice. One such facility extended by the Act is in Section 66 where an officer not below the rank of Assistant Commissioner, duly approved, may **avail the services of a Chartered Accountant or Cost Accountant to conduct a detailed examination of specific areas of operations of a registered person.** Availing the services of the expert be it a Chartered Accountant or Cost Accountant is permitted by this section only when the officer considering the nature & complexity of the business and in the interest of revenue is of the opinion that:

- **Value has not been correctly declared; or**
- **Credit availed is not within the normal limits.**

It would be interesting to know how these ‘subjective’ conclusions will be drawn and how the proper officers determines what is the normal limit of input credit availed.

Question 37

XYZ Limited is looking for an auditor for getting its accounts audited as per GST. Being an expert in the indirect taxes field XYZ Limited is seeking your advice on types of audit to be envisaged as per GST Law. Explain.

Answer

Types of Audit under GST Law: GST envisages three types of Audit.

- (1) **Audit of accounts** [Section 35(5) read alongwith section 44(2) and rule 80]
- (2) **Audit by Tax Authorities** wherein the Commissioner or any officer authorised by him, can undertake audit of any registered person for such period, at such frequency and in such manner as may be prescribed. [Section 65 and rule 101]
- (3) **Special Audit** wherein the registered person can be directed to get his records including books of account examined and audited by a chartered accountant or a cost accountant during any stage of scrutiny, inquiry, investigation or any other proceedings; depending upon the complexity of the case. [Section 66 and rule 102]

Audit of Accounts [Section 35(5) read alongwith section 44(2) and rule 80]

As per sub-section 5 of section 35 read alongwith section 44(2) and rule 80 of the CGST Rules, 2017 stipulates as follows:

<p>Every registered person must get his accounts audited by a Chartered Accountant or a Cost Accountant if his aggregate turnover during a FY exceeds ₹ 5 crores.</p>	<p>Such registered person is required to furnish electronically through the common portal alongwith Annual Return a copy of:</p> <ul style="list-style-type: none"> <input type="checkbox"/> Audited annual accounts <input type="checkbox"/> A Reconciliation Statement, duly certified, in prescribed FORM GSTR-9C.
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Reconciliation Statement will **reconcile the value of supplies** declared in the return furnished for the financial year with the audited annual financial statement and such other particulars, as may be prescribed.

Audit under section 65:

Section	Description	Remarks
Section 65	Audit by tax authorities	The audit under Section 66 is a special audit to be conducted by a Chartered Accountant or Cost Accountant nominated by the Commissioner whereas the audit under Section 65 is a routine audit by the tax office.

Special Audit under section 66:

Availing the services of experts is an age old practice of due process of law. These experts have done yeoman service to the process of delivering justice. One such facility extended by the Act is in Section 66 where an officer not below the rank of Assistant Commissioner, duly approved, may **avail the services of a Chartered Accountant or Cost Accountant to conduct a detailed examination of specific areas of operations of a registered person.** Availing the services of the expert be it a Chartered Accountant or Cost Accountant is permitted by this section only when the officer considering the nature & complexity of the business and in the interest of revenue is of the

opinion that:

- **Value has not been correctly declared; or**
- **Credit availed is not within the normal limits.**

It would be interesting to know how these 'subjective' conclusions will be drawn and how the proper officers determines what is the normal limit of input credit availed.

Question 38

ABC Ltd is a printing company with aggregate turnover exceeding rupees 2 crores. XYZ & Associates is a Chartered Accountant firm which has been appointed for GST audit of ABC Ltd. Mr Sandhu, Chartered Accountant from XYZ & Associates, observes on 23 July 2019 that ABC Ltd has not filed its GSTR 3B for the month of July & its GSTR-1 return is also not complied with. What should Mr Sandhu advise the client before conducting GST audit of ABC Ltd.

Answer

The auditor should advise the company to file all the GSTR-3B, GSTR-1 and annual returns before conducting GST audit so that auditor can validate and verify the returns filed by the company, verification of ITC claimed, verification of output GST liability discharged by the company and for collation of return workings and reconciliations. Auditor needs to have a comprehensive picture of -

- (i) Understanding of the **back-up of monthly returns as well as annual return** and understanding of reports generated by the GSTN portal as well as internal records of the company.
- (ii) Understanding of the **eligibility of Input Tax Credit (ITC) availed** i.e. whether ITC availed by the company is creditable or not and understanding of reversal of ITC undertaken or applicable (if any).
- (iii) Understanding of the **taxability of outward supplies and transactions covered under Reverse Charge Mechanism** and other miscellaneous/ specific transactions and understanding of the positions taken on various transactions by the company.

Question 39

In terms of **Sl. No. 5G of Form GSTR 9C**, the turnovers included in the audited financial statement for the period April 2017 to June 2017 shall be declared and deducted from the annual turnover to arrive at the turnover as per the GST Laws.

Please specify which of the following supplies would form part of reporting under turnover for the period April 2017 to June 2017

- (a) Goods were manufactured and cleared from a factory on 1.6.2017 on sale or approval basis. The goods were not approved by the recipient and returned back on 25.12.2017.
- (b) Goods were manufactured and cleared from a factory located in Bangalore on 30.4.2017. The goods were cleared to its showroom located in Hyderabad and eventually been sold from there on 30.8.2017. The audit under the GST Law will be conducted for Bangalore GSTIN.
- (c) Continuous supply of service in the nature of telecommunication service has been provided for the period 1.6.2017 to 30.6.2017. The bill is raised on 3.7.2017. The bill is payable by the

customer only on 21.7.2017. Should the revenue be recognised in the month of June 2017 and reduced from total turnover or should it form part of turnover for the period July 2017 to March 2018 since the due date for payment of consideration is 21.7 2017. The entity recognised the revenue in the month of June 2017.

Answer

- (a)** Since the goods were not approved and returned after the stipulated period of 6 months, the **value of the said supplies would not be included in turnover** in the audited financial statements. However, as per the 2nd proviso to Section 142(12) of the CGST Act since the goods were returned after 6 months from appointed date (i.e. 1.6.2017), GST would be payable for the tax period December 2017. Though the transaction originated in the period April 2017 to June 2017, the turnover will not be reflected under this Sl.No. However, one may reflect such adjustment under Part II, sl. No. 5 Clause O – ‘Adjustments in turnover due to reasons not listed above’ as addition.
- (b)** The **said goods are liable to excise duty since the goods have been cleared on 30.4.2017.** The goods would not form part of turnover as per the financial statements since it is a branch transfer. It would stand reflected as branch transfers under the State Level VAT laws. Since audit is being conducted for Bangalore GSTIN and since supply has occurred from Hyderabad GSTIN, it would not be necessary to make adjustments for the period April 2017 to June 2017.
- (c)** As per proviso to Rule 3(b) of the Clause of Taxation Rules, 2011, **the point of taxation in the impugned case would be the date on which bill has been raised i.e. 3.7.2017.** Though invoice has been raised in the GST regime, service tax is payable since service has been provided during the currency of the Finance Act, 1994. The date for payment of service tax as per the machinery provision i.e. POTR, 2011 may be 3.7.2017 but the said service would be liable to service tax because the charge u/s 66B gets attracted for the period June 2017. Further as per S.142(11)(b) since if a transaction is liable for service tax, then tax would not be payable under the GST Laws. Hence the said amount should be deducted as turnover under this Sl. No. for the period April 2017 to June 2017.

Question 40

As the auditor appointed under the GST Act, 2017, how would you verify 'Unbilled transactions at the beginning of the financial year'?

Answer

Verification of Unbilled revenue at the beginning of Financial Year: To comprehend the scope of these Sl. Nos, there is need to understand the concept of 'Unbilled revenue'. In simple terms, **unbilled revenue is the revenue recognized in the books of accounts before the issue of an invoice at the end of a particular period.** Accounting Standard- 9 / IND AS 115 provides for recognition of revenue on **full completion / partial completion** of the services though the due date for issuing invoice as per the contract would be on a later date.

Clause 5B requires the addition of unbilled revenue at the beginning of a Financial Year. Unbilled revenue which was recorded in the books of accounts on the basis of accrual system of accounting in the earlier financial year for which the invoice is issued under the GST law is required to be declared here. In other words, when GST is payable during the financial year on such revenue (which was recognized as income in the earlier year), the value of such revenue is to be declared

here.

Unbilled revenue would appear in the profit and loss account of the previous year. For information of unbilled revenue at the beginning of a Financial Year, reference may be made to previous year's audited financial statements.

Question 41

While conducting GST audit of PQR Ltd, you have observed the following:

PQR Limited has exported goods to a Company located in USA. The value of goods is \$100,000. The exchange rate on the date of filing Shipping Bill is: CBEC notified ₹ 65 and RBI Reference rate ₹ 68.

At the time of receiving money, the bank exchanged the foreign currency at ₹ 70.

How would you report the adjustments in turnover due to foreign exchange fluctuations in Reconciliation statement in Form GSTR 9C prescribed in terms of Rule 80(3) of CGST Rules, 2017.

Answer

Reporting of Adjustment in Turnover due to Foreign Exchange Fluctuations in Reconciliation Statement: Any difference between the turnover reported in the Annual Return (GSTR9) and turnover reported in the audited Annual Financial Statement due to foreign exchange fluctuations shall be declared in Sl. No. 5N. Adjustments in turnover due to foreign exchange fluctuations.

For the purpose of GST Returns, the exchange rate would be ₹ 65 and the exports to be disclosed in the GST Returns would be ₹ 65,00,000. For the purpose of accounting records, the exchange rate would be ₹ 68 and the exports recorded in the books would be ₹ 68,00,000. The difference in revenue being ₹ 300,000 would have to be **reduced** from the Annual turnover as per the financials to arrive at the revenue as per GSTR 9.

Additionally, difference in the amount booked in the accounts and actual amount received being ₹ 70 - ₹ 68 = ₹ 2 x \$100,000 = ₹ 200,000 would be credited to the Profit and Loss Account as Forex Gain which again needs to be **reduced** from the Annual turnover as per the financials to arrive at the revenue as per GSTR 9.

Question 42

MM & Co., a footwear manufacturer is registered with GST in Delhi and its branches registered in Punjab & Haryana. Its turnover for the FY ended 31st March, 2019 is: Delhi: ₹ 1.8 crore, Punjab: ₹ 1.2 crore and Haryana: ₹ 2.7 crore. However, the branch registered in Punjab is making only exempt supplies. The management of the company is of the view that GST audit is not applicable on them. Whether, their contention is correct or not. Substantiate.

Answer

GST audit will be applicable on MM & Co. As per section 35(5) read with rule 80(3), the **aggregate turnover calculation** for the applicability of GST audit **must be done on a PAN India basis**, which means that **once the turnover under the PAN India level is more than ₹ 5 crores, all business entities registered under GST for that PAN will be liable for GST audit for the FY.** Further, aggregate turnover includes exempted supplies. Therefore, **any person making exempt**

supplies which is registered under GST will also be liable for GST audit.

Thus, in the given case, the contention of the management is not correct. The aggregate turnover of the company is ₹ 5.7 crore. **Thus, each branch is liable for GST audit.**

Question 43

Mr. A was appointed as an auditor of M/s. XYZ Co. During the course of audit he finds that the company has availed an excess ITC of ₹50 lakh. Accordingly, he made recommendations in Part V of GSTR-9C, The management of the company refused to pay the excess ITC and argued that auditors recommendations are not binding. Comment.

Answer

The **management contention is correct**. The **auditor has only a recommendatory power**, for recommendations given by the auditor may or may not be acceptable to the registered person. The **registered person has the option to accept, reject or partially accept** the recommended additional tax liability. In line with such recommendations, though not explicitly stated anywhere in the relevant Form or GST law –

- (i) the registered person **can choose to make the payment of the additional tax liability** in full or in part;
- (ii) the registered person **can even choose to reject the complete recommendations of the auditor** and not make the payment at all.

Question 44

Mr. John, made an outward supply of ₹ 4.00 lakhs to M/s. Taj Enterprises on 30th April, 2020 on a credit period of 15 days. However, M/s. Taj Enterprises made the payment to Mr. John after 45 days along with interest for 30 days delayed payment @ 12%. As such, Mr. John received total payment of ₹ 4,04,000/- along with interest. However, while filing Form GSTR- 3B/ Form GSTR-1, Mr. John declared his outward supplies at ₹ 4.00 lakhs. Even while filing Form GSTR-9, Mr. John did not discharge his tax liability. As a GST auditor in Form GSTR- 9C, what action is recommended by the auditors. Comment.

Answer

In terms of section 15(2)(d) while computing value of taxable supply the **transaction value shall include interest or late fee or penalty for delayed payment of any consideration** for any supply. Since, Mr. John did not pay tax on interest component, **he made violation of valuation provisions**. Mr. John was having option to discharge such liability at the time of filing of Form GSTR-9, which he did not avail. Therefore, the **GST auditor may recommend him to discharge such liability** at the time of making reconciliation statement in Form GSTR-9C.

Question 45

CA Natraj, proprietor of Satyam & Co., Chartered Accountants, while doing GST audit in Form GSTR-9C, recommended additional liability of ₹ 1.5 crore to be paid by PQR Co. Ltd. on account of supplies

not declared in regular returns in Form GSTR-3B/ Form GSTR-1 and also in annual return in Form GSTR-9. The company agreed to pay the liability. On the date of payment, it had ITC of ₹ 1 crore in its electronic credit ledger which the company wants to use for making the payment and balance amount to be paid in cash. Comment.

Answer

The **management is not correct** in doing so. If the registered person chooses to make the payment of any additional liability as recommended by the auditor, the **company may make such payment through FORM DRC-03**. However, such liability **shall be paid through electronic cash ledger only**.

Question 46

M/s. Ramo & Co (P) Ltd. while appointing M/s. Jatin Prasad & Associates, a CA firm, as their GST auditors for the FY 2020-21 claims that only a GST Practitioner CA firm is eligible for doing audit under GST law in terms of section 35(5) of the Act. Comment.

Answer

The GST Act/ Rules do not vest a GST practitioner with the power to audit under section 35(5). The **power to audit is granted only to a chartered accountant or cost accountant who is in practice**. Therefore, a chartered accountant is not required to be registered as a GST practitioner for the purpose of certifying FORM GSTR-9C. Therefore, the **contention of the company** that only a GST Practitioner CA is eligible for GST audit **is not correct**.

Question 47

State the consequences of not filing of Annual Return in Form GSTR-9 and not getting the GST Audit done u/s. 35(5) of the Act, in Form GSTR-9C?

Answer

Section 47(2) provides that in case of failure to submit the annual return within the specified time, **a late fee shall be levied**. The said late fee would be **₹ 100 per day during which such failure continues subject to a maximum of a quarter percent of the turnover** in the State/UT. There would be an equal amount of late fee under the respective SGST/ UTGST Act.

However, there is **no specific penalty prescribed in the GST Law** for not getting the accounts audited by a chartered accountant or a cost accountant. Therefore, in terms of **section 125** of the CGST Act, the registered person may be subjected to a **penalty of up to ₹ 25,000/-**. This section deals with the general penalty that gets attracted where any person, who contravenes any of the provisions of this Act, or any rules made thereunder for which no penalty is separately provided. Similar provision also exists under the SGST/ UTGST Act as well. As such, penalty of up to ₹ 25,000/- shall be imposed under the SGST/ UTGST Act. It is possible that since the annual return in FORM GSTR-9 is to be accompanied with the auditor's report in FORM GSTR-9C, if not done it may amount to non-filing of annual return and late fee also may be levied.

Question 48

What are the objectives of Special Audit under section 66 of the CGST Act. Can it be invoked in a routine manner by proper officer?

Answer

The objectives of Special Audit under section 66 of the CGST Act is that **if at any stage of scrutiny, inquiry, investigation** or any other proceedings before him, **any officer not below the rank of Assistant Commissioner**, having regard to the nature and complexity of the case and the interest of revenue, is of the opinion that the **value has not been correctly declared or the credit availed is not within the normal limits**, he may, with the prior approval of the Commissioner, direct such registered person by a communication in writing to get his records including books of account examined and **audited by a chartered accountant or a cost accountant as may be nominated by the Commissioner**. Therefore, it cannot be invoked in a routine manner by proper officer.

Question 49

Write a short note on differences in Audit by Tax Authorities and the Special Audit?

Answer

There are differences in Audit by Tax Authorities and the Special Audit. Such differences can be analysed as under-

- (1) The **audit by tax authorities is conducted by the revenue officers** whereas **special audit is conducted by the CA/ Cost Accountants** on the penal of the department.
- (2) The **audit by tax authorities** is conducted by the revenue officers **either the taxpayer's office or at their own office** whereas **special audit** is conducted by the CA/ Cost Accountants **at the taxpayer's office**.
- (3) The **audit by tax authorities can be invoked in a routine manner** by the revenue officers whereas **special audit is invoked with the prior approval of the Commissioner** if the nature of business of the auditee is found to be complex.
- (4) The **audit by tax authorities is to be completed within 3 months** which is further extendable by another 6 months, whereas **special audit is to be completed within 90 days** which is further extendable by another 90 days.

Question 50

State the scope of audit under GST, whether inspection or fait accompli?

Answer

The **scope of inspection by the tax authorities is much wider** which may entail inspection, search and seizure at the business premises and the vehicles of the **taxable person**. Such powers are used by the authorities in special circumstances **when the proper officer not below the rank of Joint Commissioner has reason to believe that there is evasion of tax by the taxpayer**.

As compared to inspection, the scope of audit is very limited up to fait accompli in the case of **registered person**. **Fait accompli is a thing that has already happened** or has been decided before those affected about it, leaving them with no option but to accept or reject it. E.g. the results were presented to shareholders as a fait accompli. Therefore, the **auditors are not having powers to inspect the premises or vehicles of the registered person** but to make the checking of the records, books of accounts, audited financial statements or the returns etc. filed by him.

Question 51

Whether filing of Annual Return in Form GSTR-9 is mandatory for all registered persons? If not then what are the exceptions?

Answer

Filing of Annual Return in Form GSTR-9 is mandatory for all registered persons except the following-

- **Casual taxable persons**
- **Input service distributors**
- **Non-resident taxable persons**
- **Persons paying TDS/ TCS** under section 51/ 52 of the Act
- Person supplying **online information** and database access retrieval services
- Persons having **GTO < 2.00 crore** are having option to file and not to file the Annual Return

Question 52

The GST department endeavours to collect legitimate taxes while requiring the taxpayers to file FORM GSTR-9 and FORM GSTR-9C. Can you draw a comparative view of these two forms?

Answer

COMPARATIVE VIEW OF FORM GSTR-9 AND GSTR-9C

S. No.	FORM GSTR-9	FORM GSTR-9C
1.	It is annual report of a formal or official character giving information	It is auditor's report reconciling audited financial statements with FORM GSTR-9
2.	Enacted under section 44 read with rule 80	Enacted under section 35(5)/ 44 read with rule 80
3.	Filing of FORM GSTR-9 is mandatory for all registered persons without any threshold limit. [Upto 2.00 crore optional]	To be filed only if the aggregate turnover in a FY exceeds the prescribed limit which 5.00 crore at present.

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4.	Not required to be filed by a Casual Taxable Person, Non-Resident Taxable Person, Input Service Distributor, Unique Identification Number Holders, Online Information and Database Access Retrieval Service, Composition Dealers, persons required to deduct taxes under section 51 and persons required to collect taxes under section 52.	Not required to be filed by a Casual Taxable Person, Non-Resident Taxable Person, Input Service Distributor, Unique Identification Number Holders, Online Information and Database Access Retrieval Service, Composition Dealers, persons required to deduct taxes under section 51, persons required to collect taxes under section 52, Government Department subject to CAG audit and foreign airline company.
5.	No need to annex financials	Financials to be annexed
6.	The annual return is to be filed by the registered person.	Reconciliation statement in FORM GSTR-9C is to be given by auditors and to be filed by the registered person.
7.	The annual return is to be prepared based on consolidated information from periodical returns like FORM GSTR-3B/ FORM GSTR-1.	The reconciliation statement is to be prepared for reconciling the information in the annual return viz. a viz. the audited annual financial statement.
8.	The annual return is to be verified by the registered person.	The reconciliation statement is to be certified by the auditors.

Question 53

Mr. Ramanuj, a Chartered Accountant by profession, has been appointed as GST auditor for ABC Ltd. The management has asked Mr. Ramanuj for GST audit and to file GSTR-3B for the months of July and August 2019 and filing of annual return in FORM GSTR-9. Mr. Ramanuj contended that he has been appointed only for GST audit and the above are his scope limitations and cannot be conducted as the compliances and returns are to be filed by the management. In context of above dispute, you have to suggest whether the contention of Mr. Ramanuj is correct or not. Justify.

Answer

Responsibility of Compliances and filing of Returns: GST auditor's prime responsibility on this engagement is limited to GST audit, audit of reconciliation statement between books of accounts vis-a-vis GST returns prepared by the Company. The GST auditor is, however, **not responsible for any compliances like uploading GST periodic returns for the relevant audit period.**

Since, in the given situation, Management has asked the auditor Mr. Ramanuj to conduct besides GST Audit filing of GSTR-3B for the months of July and August 2019 and filing of annual return in FORM GSTR-9.

Accordingly, Mr. Ramanuj has **rightly refused that his scope is limited to GST Audit** and the scope does not cover any of the management functions.

In view of above, **Contention of Management to Ramanuj is not tenable** as preparation of annual returns and its filing was the responsibility of management.

Chapter 13

Audit of Public Sector Undertakings

Question 1

BT Ltd , a company wholly owned by central government was disinvested during the previous year, resulting in 40% of the shares being held by public. The shares were also listed on the BSE. Since the shares were listed, all the listing requirements were applicable, including publication of quarterly results, submission of information to the BSE etc.

Sam, the FM of the company is of the opinion that now the company is subject to stringent control by BSE and the markets, therefore the auditing requirements of a limited company in private sector under the Companies Act 2013 would be applicable to the company and the C&AG will not have any role to play. Comment.

Answer

Section 2(45) of the Companies Act, 2013, defines a “Government Company” as a company in which **not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.** The auditors of these government companies are firms of Chartered Accountants, **appointed by the Comptroller & Auditor General**, who gives the auditor directions on the manner in which the audit should be conducted by them. The **listing of company’s shares on a stock exchange is irrelevant** for this purpose and hence **Sam’s opinion is not correct.**

Question 2

What are the principles involved regarding “Propriety audit’ in the case of Public Sector Undertaking?

Answer

Companies Act, lays down special provisions regarding audit of accounts of public sector undertakings registered as Government Companies. Section 143 of the Companies Act, 2013 empowers C&AG to conduct supplementary or test audit. **Audit of public enterprises in India is not restricted to financial and compliance audit; it extends also to efficiency, economy and effectiveness** with which these operate and fulfill their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety. **Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct.** On an analysis, these tests boil down to tests of economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, **it shifts the emphasis to the substance of transactions** and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is

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also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances. Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial

propriety. Audit against propriety seeks to ensure that expenditure conforms to these **principles** which **have been stated as follows:**

- (i) The **expenditure should not be prima facie more than the occasion demands.** Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- (ii) No authority should **exercise its powers of sanctioning expenditure** to pass an order which will be directly or indirectly **to its own advantage.**
- (iii) **Public moneys should not be utilised for the benefit of a particular person** or section of the community.
- (iv) Apart from the agreed remuneration or reward, **no other avenue is kept open to indirectly benefit the management personnel, employees and others.**

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The aim of propriety audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper; avoidable and in fructuous expenditure.

Question 3

Write a short explanatory note on areas of propriety audit under Section 143(1) of the Companies Act, 2013.

Answer

Areas of Propriety Audit under Section 143(1): Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to -

- (i) whether **loans and advances made by the company on the basis of security have been properly secured** and whether the **terms** on which they have been made are **prejudicial to the interests** of the company or its members;
- (ii) whether **transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;** Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made;
- (iii) where the company not being an investment company or a banking company, whether so much of the **assets** of the company as consist of shares, debentures and other securities have been **sold at a price less than** that at which they were **purchased by the company;**
- (iv) whether **loans and advances** made by the company have been shown as **deposits;**
- (v) whether **personal expenses** have been charged to **revenue account;**
- (vi) where it is stated in the books and documents of the company that **any shares have been allotted for cash, whether cash has actually been received** in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account

books and the balance sheet is correct, regular and not misleading.

A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.

Question 4

Write a short explanatory note on Role of C&AG in the Audit of a Government company.

Or

Ceta Ltd. is a company in which 54% of the paid up share capital is held by Rajasthan Government. The company is engaged in the business of providing consultancy services in relation to construction projects. The audit of the financial statements of Ceta Ltd. for the financial year ended 31 March 2021 got completed with lot of intervention of Comptroller & Auditor General of India, wherein C&AG was giving directions to the auditors on the manner in which audit should be conducted in respect of certain areas. Further, it also received comments from C&AG on the audit report of the auditors. Ceta Ltd is seeking advice to go against C&AG so that they can avoid unnecessary interference of C&AG. You are required to advise Ceta Ltd. with respect to role of C&AG in the audit of a Government company.

Answer

Role of C&AG in the Audit of a Government company: Role of C&AG is prescribed under sub section (5), (6) and (7) of section 143 of the Companies Act, 2013.

In the case of a Government company, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 i.e. appointment of First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report have a right to:

- (i) **conduct a supplementary audit of the financial statement of the company** by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
- (ii) **comment upon or supplement such audit report.**

It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

Test Audit: Further, without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139, if he considers necessary, by an order, cause test audit to be

conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Question 5

Being an expert in the field of government audit, you are required to briefly explain the powers of Comptroller and Auditor General of India with respect to supplementary audit and test audit as stated under section 143(6) and 143(7) of the Companies Act, 2013.

Answer

Powers of Comptroller and Auditor-General of India

(i) Supplementary audit under section 143(6)(a) of the Companies Act, 2013:

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct.

Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013: Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 of the said Act i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(ii) Test audit under section 143(7) of the Companies Act, 2013: Without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139 of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Question 6

Tee & Co., a firm of Chartered Accountants had been appointed by C & AG to conduct statutory audit of M/s Rare Airlines Limited, a Public Sector Company. They would like to check certain mandatory propriety points as required under section 143 (1) of the Companies Act, 2013. List the areas of check to meet these requirements.

Answer

Mandatory Propriety Points under section 143 (1) of the Companies Act, 2013: The requirement of the provisions of section 143(1) is essentially propriety-oriented as much as some specific dubious practices are required to be looked into by the auditor. Areas of propriety audit under the provisions of Section 143(1) may be following:

(i) Whether the terms on which secured loans and secured advances have been made are prejudicial to the interests of the company or its members": It may be appreciated that the terms of loans include such matters as security, interest, repayment period and

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other business considerations. The auditor has to inquire whether the terms are such that they can be adjudged as prejudicial to the legitimate interest of the company or of its shareholders. This is a process of judging a situation by reference to certain objective standards or reasonableness whether the terms entered into are prejudicial or not, not only to the company but also to the shareholders.

- (ii) **Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company:** This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards. It is also possible that some transactions may not adversely affect the interests of the company. The auditor has to judiciously consider what does and does not constitute the interest of the company.
- (iii) **Whether investment of companies, other than a banking or an investment company, in the form of shares, debentures and other securities have been sold at a price lower than the cost:** Apparently, this is a matter of verification by the auditor. The intention, however, is not known whether loss has occurred due to the sale. The auditor is required to inquire into circumstances of sale of investments that resulted in loss. Obviously, the duty cast on him is propriety based, i.e., reasonableness of the decision to sell at a loss. It involves exercise of judgment having regard to the circumstances in which the company was placed at the time of making the sale.
- (iv) **Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made:**
- (v) **Whether personal expenses have been charged to revenue:** It is an accepted principle that expenses which are not business expenses should not be charged to revenue. The effect of charging personal expenses to the business is to distort the profitability of the company and to secure a personal gain at the cost of the company. Obviously, propriety is involved in this; charging personal expenses to business account is highly improper and abusive hence this provision.
- (vi) **In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading:** A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.

Question 7

On receipt of statutory audit report on 30-03-2020 of M/s Sunlight Ltd., a government company, C&AG on 25-05-2020 appointed M/s Veeru & Associates to conduct supplementary audit u/s 143(6)(a) of the Companies Act, 2013. They submitted their report to C&AG as per their scope of work. The Company held its AGM on 01-09-2020 but directors did not think it necessary to discuss supplementary auditor's report and comment of the C&AG. Is the approach of the directors of Sunlight Ltd. correct? Guide the company with the provisions related to supplementary audit.

Answer

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to,

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- (i) **conduct a supplementary audit under section 143(6)(a)**, of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and
- (ii) **comment upon or supplement such audit report under section 143(6)(b)**: It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

In view of above provisions, the approach of directors of Sunlight Ltd. is not correct. They are required to mandatory send the Supplementary Audit Report and comments of C&AG to every member of the company etc. as prescribed and also be placed before the annual general meeting of the company in the same manner as in case of audit report. Since in the given case neither the report has been distributed nor discussed in the Annual General Meeting, the directors of the company will be liable for contravention of aforesaid sections.

Question 8

"The C & AG may direct the appointed auditor about the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India". What are the relevant sections of the Companies Act, 2013 and steps involved in the audit of Government Companies?

Answer

The following steps are involved in the audit of government companies:

- (i) **Appointment of Auditors under Section 139(5) and 139(7) read with section 143(5) of the Companies Act, 2013** - Statutory auditors of Government Companies are appointed or re-appointed by the C&AG. There is thus, a departure from the practice in vogue in the case of private sector companies where appointment or re- appointment of the auditors and their remuneration are decided by the members at the annual general meetings. In the case of government companies, though the appointment of statutory auditors is done by the C&AG, the remuneration is left to the individual companies to decide based on certain guidelines given by the C&AG in this regard.
- (ii) **The C&AG may direct the appointed auditor** on the manner in which the accounts of the Government company are required to be audited and the auditor so appointed has to submit a copy of the audit report to the Comptroller and Auditor-General of India. The report, among other things, includes the directions, if any, issued by the C&AG, the action taken thereon and its impact on the accounts and financial statement of the company.

The report under section 143(5) is in addition to the reports issued by the Statutory Auditors under various other clauses of section 143.

- (iii) **Supplementary audit under section 143(6)(a) of the Companies Act, 2013** -The Comptroller and Auditor-General of India shall **within 60 days** from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statements of

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the government company by such person or persons as he may authorize in this behalf and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the C&AG may direct.

- (iv) **Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013** - Any comments given by the C&AG upon, or in supplement to, the audit report issued by the statutory auditors **shall be sent by the company to every person entitled** to copies of audited financial statements **under sub-section (1) of section 136** of the said Act i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be **placed before the annual general meeting of the company** at the same time and in the same manner as the audit report.
- (v) **Test audit under section 143(7) of the Companies Act, 2013** -Without prejudice to the provisions relating to audit and auditor, the C&AG may, in case of any company covered under **sub-section (5) or sub-section (7) of section 139** of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of **section 19A of the Comptroller and Auditor- General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.**

Question 9

Write short note on areas covered in Comprehensive Audit.

Answer

The areas covered in comprehensive audit will **naturally vary from enterprise to enterprise** depending on the nature of the enterprise, its objectives and operations. **Some of the broad areas are listed below:**

- **Comparison of overall capital cost** of the project with the approved planned costs.
- **Production or operational outputs** vis-a-vis under-utilisation of the installed capacity.
- **Systems of project formulation** and implementation.
- **Planned rate of return.**
- **Cost control measures.**
- **Research and development programmes.**
- **System of repairs and maintenance.**
- **adequate purchase policies.**
- **Effective and economical procedures.**
- **Project planning.**
- **Undue waste**, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources.

Question 10

Sunlight Limited is a public sector undertaking engaged in production of electricity from solar power. It had commissioned a new project near Goa with a new technology for a cost of ₹ 5,750

crore. The project had seen delay in commencement and cost overrun. State the matters that a Comprehensive Audit by C&AG may cover in reporting on the performance and efficiency of this project.

Or

XYZ & Co., a CA. firm was appointed by C&AG to conduct comprehensive audit of ABC Public undertaking. C&AG advised to cover areas such as investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc. Discuss stating the issues examined in comprehensive audit.

Answer

Matters covered in Reporting in case of Comprehensive Audit are: To facilitate a proper consideration, the reports of the C&AG on the audit of PSUs are presented to the Parliament in several parts consisting of results of comprehensive appraisals of selected undertakings conducted by the Audit Board etc. **Some of the issues examined in comprehensive audit are:**

- (i) How does the **overall capital cost of the project** compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?
- (ii) Have the **accepted production or operational outputs** been achieved? Has there been under-utilization of installed capacity or shortfall in performance and, if so, what has caused it?
- (iii) Has the **planned rate of return** been achieved?
- (iv) Are the **systems of project formulation** and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?
- (v) Are **cost control measures** adequate and are there inefficiencies, wastages in raw materials consumption, etc.?
- (vi) Are the **purchase policies adequate**? Or have they led to piling up of inventory resulting in redundancy in stores and spares?
- (vii) Does the enterprise have **research and development programmes**? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?
- (viii) If the enterprise has an **adequate system of repairs and maintenance**?
- (ix) Are **procedures effective and economical**?
- (x) Is there any poor or insufficient or **inefficient project planning**?

Question 11

“A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.” Briefly discuss the issues addressed by Performance Audits conducted in accordance with the guidelines issued by C&AG.

Answer

According to the guidelines issued by the C&AG, Performance Audits usually address the

issues of:

- (i) **Economy-** It is **minimising the cost of resources** used for an activity, having regard to appropriate quantity, quality and at the best price.

Judging economy implies forming an opinion on the resources (**e.g. human, financial and material**) deployed. This requires assessing whether the given resources have been used economically and acquired in due time, in appropriate quantity and quality at the best price.

- (ii) **Efficiency-** It is the **input-output ratio**. In the case of public spending, efficiency is achieved when the **output is maximised at the minimum of inputs**, or input is minimised for any given quantity and quality of output.

Auditing efficiency embraces aspects such as whether:

- (a) **sound procurement practices** are followed;
 - (b) resources are properly protected and maintained;
 - (c) human, financial and other resources are efficiently used;
 - (d) **optimum amount of resources** (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;
 - (e) public sector programmes, entities and **activities are efficiently managed**, regulated, organised and executed;
 - (f) efficient **operating procedures** are used; and
 - (g) the **objectives** of public sector programmes are **met cost-effectively**.
- (iii) **Effectiveness-** It is the **extent to which objectives are achieved** and the relationship between the intended impact and the actual impact of an activity.

In auditing effectiveness, performance audit may, for instance:

- (a) assess whether the objectives of and the means provided (legal, financial, etc.) for a new or ongoing public sector programme are proper, consistent, suitable or relevant to the policy;
- (b) determine the extent to which a program achieves a **desired level of program results**;
- (c) assess and establish with evidence whether the observed direct or indirect social and economic impacts of a policy are due to the policy or to other causes;
- (d) identify **factors inhibiting satisfactory performance** or goal-fulfilment;
- (e) assess whether the programme complements, duplicates, overlaps or counteracts other related programmes;
- (f) assess the effectiveness of the program and/or of individual program components;
- (g) determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
- (h) assess the **adequacy of the management control system** for measuring, monitoring and reporting a programme's effectiveness;
- (i) assess **compliance with laws and regulations** applicable to the program; and
- (j) identify ways of **making programmes work more effectively**.

Question 12

In carrying out efficiency audit of a Public Sector Undertaking (PSU), what important aspects are required to be looked into, to assess the efficiency?

Answer

Aspects to be looked into, to assess the efficiency- It is the **input-output ratio**. In the case of public spending, efficiency is achieved when the **output is maximised at the minimum of inputs**, or input is minimised for any given quantity and quality of output.

Auditing efficiency embraces aspects such as whether:

- (i) **sound procurement practices** are followed;
- (ii) resources are properly protected and maintained;
- (iii) human, financial and other **resources are efficiently used**;
- (iv) **optimum amount of resources** (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;
- (v) public sector programmes, entities and activities are efficiently managed, regulated, organised and executed;
- (vi) efficient **operating procedures** are used; and
- (vii) the **objectives** of public sector programmes are **met cost-effectively**.

Question 13

The Board of Directors of XYZ Ltd. is concerned with decreasing operating efficiency in material consumption. As an Auditor entrusted with investigating the causes for this poor state, what may be the areas of your focus in this respect.

Answer

Decreasing Operating Efficiency in Material Consumption: It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximized at the minimum of inputs, or input is minimized for any given quantity and quality of output.

- The auditor should make an **analytical procedure to compare the material consumption** with output for the current year as well as previous years.
- The **internal control system** should be studied.
- The auditor should have discussions/ **inquiry with different personnel** of the company including production personnel.
- The **production process**, scheduling, machine usage, material mix should be studied.
- A **reconciliation of variation** as to various causes – Price, quantity efficiency are to be analyzed.
- The **budget, standard costing and other MIS reports** should be called for & studied.
- **Internal audit report should be thoroughly studied** and whether any pilferage, fraud etc. were noticed. These are to be looked into.
- The **key material should be picked up for detailed study** of their ordering, receipts, issue, normal loss yield percentage etc.

Question 14

ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. What factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry?

Answer

Factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry:

- **Understanding the entity/programme**
- Defining the **objectives** and the scope of audit
- Determining **audit criteria**
- Deciding **audit approach**
- Developing **audit questions**
- Assessing **audit team skills** and whether outside expertise required
- Preparing **Audit Design Matrix**
- Establishing **time table and resources**
- Intimation of **Audit programme** to audit entities

Question 15

You have been appointed as auditor of a AKY Ltd. After having determined the audit objectives, now you have been requested to draft audit criteria. What are the sources that you will use while doing the task?

Answer

Determining Audit Criteria - Audit criteria are the **standards** used to determine whether a **program meets or exceeds expectations**. It provides a context for understanding the results of the audit. Audit criteria are **reasonable and attainable standards of performance** against which **economy, efficiency and effectiveness** of programmes and activities can be **assessed**.

The audit criteria may be sought to be **obtained from the following sources:**

- (i) **procedure manuals** of the entity.
- (ii) **policies**, standards, directives and guidelines.
- (iii) **criteria used by the same entity or other entities** in similar activities or programmes.
- (iv) **independent expert opinion** and know how.
- (v) new or established **scientific knowledge** and other reliable information.
- (vi) general management and subject matter **literature and research papers**.

Question 16

Write a short note on issues addressed in Performance Audit of PSUs

Answer

Issues Addressed in Performance Audit:

Audit of Public Sector Undertakings

Performance Audit: An objective and **systematic examination of evidences** for the purpose of providing an **independent assessment of the performance of a government organization**, program, activity or function in order to provide information **to improve public accountability and facilitate decision making** by parties with responsibility to oversee or initiate corrective action. It is conducted by C&AG. **Performance Audit addresses the following issues:**

- (i) **Economy-** It is **minimising the cost of resources** used for an activity, having regard to appropriate quantity, quality and at the best price whether given resources have been used economically.
- (ii) **Efficiency-** It is the **input-output ratio**. In the case of public spending, efficiency is achieved when the output is maximized at minimum inputs or input is minimized for any given quantity and quality of output
- (iii) **Effectiveness-** It is the **extent to which objectives are achieved** and the relationship between the intended impact and the actual impact of an activity.

Question 17

The reports of the Comptroller and Auditor General of India on the audit of PSUs are presented to the Parliament and to various state legislatures to facilitate a proper consideration. Enumerate the contents of Audit Report presented by C&AG.

Answer

Contents of Audit Report of the Comptroller and Auditor General: For facility of consideration, the reports of the Comptroller and Auditor General on the public sector undertakings of the Central Government are **presented to the Parliament in several parts consisting of the following:**

- (i) **Introduction containing a general review** of the working results of Government companies, deemed Government companies and corporations.
- (ii) **Results of comprehensive appraisals** of selected undertakings conducted by the Audit Board.
- (iii) **Resume of the company auditors' reports** submitted by them under the directions issued by the Comptroller and Auditor General and that of comments on the accounts of the Government companies.
- (iv) **Significant results of audit of the undertakings** not taken up for appraisal by the Audit Board.

For certain specified states, the Comptroller and Auditor General submit a separate audit report (commercial) to the legislature, while for other States/Union Territories with legislature, there is a commercial chapter in the main audit report. The State audit reports, contains **both the results of audit appraisal of performance** of selected companies/corporations **as well as important individual instances of financial irregularities**, wasteful expenditure, system deficiencies noticed by the statutory auditors, comments noticed in Government audit in the audit functions of certification of accounts and a general review of the working results of Government companies and corporations.

Chapter 14

Liabilities of Auditor

Question 1

Indicate the precise nature of auditor's liability in the following situations and support your views with authority, if any:

- (i) A misstatement had occurred in the prospectus issued by the company.
- (ii) Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.
- (iii) Based upon the legal opinion of a leading advocate, X Ltd. made a provision of ₹ 3 crores towards Income Tax liability. The assessing authority has worked out the liability at ₹ 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.

Answer

- (i) **Damages for negligence:** Civil liability for mis-statement in prospectus under section 35 of the Companies Act, 2013, are:

Where a **person has subscribed for securities** of a company acting **on any statement** included, or the inclusion or omission of any matter, in the prospectus **which is misleading and has sustained any loss or damage** as a consequence thereof, the **company and every person who—**

- (a) is a **director of the company** at the time of the issue of the prospectus;
- (b) has **authorized himself to be named and is named the prospectus** as a director of the company or has agreed to become such director either immediately or after an interval of time;
- (c) is a **promoter** of the company;
- (d) has **authorised the issue of the prospectus**; and
- (e) is an **expert** referred to in sub-section (5) of section 26,

shall, without prejudice to any punishment to which any person may be liable under section 36, be **liable to pay compensation to every person who has sustained such loss or damage.**

- (ii) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the under noted considerations:
- (a) Whether the **defalcation emanated from the weaknesses noticed by the statutory auditor**, the information regarding which was passed on to the management; and
 - (b) Whether the **statutory auditor properly and adequately extended the audit**



programme of the previous year having regard to the weaknesses noticed.

SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" clearly mentions that, "The auditor shall determine

whether, on the basis of the audit work performed, the **auditor has identified one or more deficiencies in internal control**. If the auditor has identified one or more deficiencies in internal control, the **auditor shall determine**, on the basis of the audit work performed, whether, individually or in combination, **they constitute significant deficiencies**. The auditor shall **communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis**. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis". The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud or error. If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. Thus, normally speaking, **as long as the auditor took due care in performing the audit work, he cannot be held liable**.

The fact that the **matter was brought to the notice of the managing director may be a good defence for the auditor as well**. According to the judgement of the classic case in re Kingston Cotton Mills Ltd., (1896) it is the duty of the auditor to probe into the depth only when his suspicion is aroused. The statutory auditor, by bringing the weakness to the notice of the managing director had alerted the management which is judicially held to be primarily responsible for protection of the assets of the company and can put forth this as defence against any claim arising subsequent to passing of the information to the management. In a similar case S.P. Catterson & Sons Ltd. (81 Acct. L. R.68), the auditor was acquitted of the charge.

- (iii) **SA 500 on "Audit Evidence"** discusses the **auditor's responsibility** in relation to and the procedures the auditor should consider in, **using the work of an expert as audit evidence**. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, **audit evidence in the form of reports, opinions, valuations and statements of an expert**, e.g., legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc. Before relying on advocate's opinion, the auditor should have seen that opinion given by the expert is **prima facie dependable**. The question states very clearly that the opinion of the advocate was inconsistent with legal position with regard to certain items. It is, perhaps, quite possible that auditor did not seek reasonable assurance as to the appropriateness of the source data, assumptions and methods used by the expert properly.

In fact, SA 500 makes it incumbent upon the part of the auditor to resolve the inconsistency by discussion with the management and the expert. In case, the experts' work does not support the related representation in the financial information the inconsistency in legal opinions could have been detected by the auditor if he had gone through the same. This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the **auditor should have rejected the opinion and insisted upon making proper provision**.

Question 2

Write a short note on - Auditor's liability in case of unlawful acts or defaults by clients.

Answer

Auditor's liability in case of unlawful Acts or defaults by clients: The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but **he is apparently not under any legal obligation to disclose the offence**. A professional accountant would himself be guilty of a criminal offence if he advises his client to commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

The Institute of Chartered Accountants of India has considered the role of chartered accountants in relation to taxation frauds by an assessee and has made the following major recommendations:

- (i) A professional accountant should keep in mind the provisions of Section 126 of the Evidence Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any communication made to him in the course of and for the purpose of his employment.
- (ii) If the fraud relates to past years when the accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past fraud does not in any way affect the current tax matters.
- (iii) In case of fraud relating to accounts examined and reported upon by the professional accountant himself, he should **advise the client to make a complete disclosure**. In case the client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and that he would make a report to the authorities that the accounts prepared or examined by him are unreliable on account of certain information obtained later. In making such a report, the contents of the information as such should not be communicated unless the client consents in writing.
- (iv) **In case of suppression** in current accounts, the client should be asked to make a **full disclosure**. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

However, it can be argued that the auditor has a professional obligation to ensure that the client is fully aware of the seriousness of the offence and to seriously consider full disclosure of matter.

It has been clearly established in various case laws that the **auditor is expected to know the contents of documents and records** and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful

Liabilities of Auditor

acts, and it is his duty to bring it to the notice of the client as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the code, an auditor cannot disclose confidential information unless permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true & fair character of accounting statements.

The question of liability of an auditor for unlawful acts or defaults by clients should be considered in the light of the broad parameters given above. However, it appears that if an auditor was aware of any unlawful act having been committed by client in respect of accounts audited by him and the unlawfulness was not rectified by proper disclosure or any other appropriate means, the auditor owes a duty to make a suitable report. If he does not, he may be held liable, if the true and fair character of the accounts has been vitiated.

Question 3

In assessment procedure of M/s Cloud Ltd., Income Tax Officer observed some irregularities. Therefore, he started investigation of Books of Accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through books he found that M/s Cloud Ltd. used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the Institute of Chartered Accountants of India saying Mr. Old had negligently performed his duties. Comment.

Answer

Liability of Auditor: "It is the auditor's responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is **satisfied with the books and documents** produced to him, he **can give his opinion** on the basis of those documents only **by exercising requisite skill and care** and observing the laid down audit procedure.

In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of M/s Cloud Ltd. Therefore, he started investigation of books of accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through the books, he found that M/s Cloud Ltd. Used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. Old had negligently performed his duties.

Mr. Old, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is **responsible for the books produced before him for audit**. He completed his audit work with official set of books only.

In this situation, as Mr. Old, **performed the auditing with due skill and diligence**; and, therefore, **no question of negligence arises**. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.

Question 4

Mr. Fresh, a newly qualified chartered accountant, wants to start practice and he requires your

advice, among other things, on criminal liabilities of an auditor under the Companies Act, 2013. Kindly guide him.

Answer

The circumstances in which an auditor can be prosecuted under the Companies Act, and the penalties to which he may be subjected are briefly stated below:

- (i) **Criminal liability for Misstatement in Prospectus** - As per Section 34 of the Companies Act, 2013, where a **prospectus issued, circulated or distributed includes any statement which is untrue or misleading** in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus **shall be liable under section 447**.

This section shall not apply to a person if he proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

- (ii) **Punishment for false statement** - According to Section 448 of the Companies Act, 2013 if in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement —
- (a) which is **false in any material particulars, knowing it to be false**; or
 - (b) which **omits any material fact, knowing it to be material**,
- he shall be **liable under section 447**.

Question 5

Anvisha Ltd. is a company engaged in the business of software development. It is one of the largest companies in this sector with a turnover of ₹ 25,000 crores. The operations of the company are increasing constantly, however, the focus of the management is more on cost cutting in the coming years to improve its profitability. In respect of the financial statements of the company which are used by various stakeholders, some fraud was observed in respect of assets reported therein due to which those stakeholders suffered damages. As a result, those stakeholders applied to Tribunal for change of auditor on the basis that auditor is colluded in the fraud.

Elucidate the power of tribunal to change the auditor of a company if found acted in a fraudulent manner as provided under sub-section (5) of section 140 of the Companies Act, 2013.

Answer

Direction by Tribunal in case auditor acted in a fraudulent manner: As per sub-section (5) of the section 140 of the Companies Act, 2013, the **Tribunal either suo motu or on an application made to it by the Central Government or by any person** concerned, if it is **satisfied that the auditor of a company** has, whether directly or indirectly, **acted in a fraudulent manner** or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, **direct the company to change its auditors**.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall **within fifteen days** of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been

passed by the Tribunal under this section **shall not be eligible to be appointed as an auditor of any company for a period of five years** from the date of passing of the order and the **auditor shall also be liable for action under section 447.**

It is hereby clarified that the case of a firm, the **liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner** or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

Question 6

What are the liabilities of a Chartered Accountant under Income Tax Act, 1961 for furnishing an incorrect statement in any report or certificate required to be submitted by him under the Act?

Answer

Liability of an Auditor under Income Tax Act: Liabilities of a Chartered Accountant under the Income Tax Act of 1961 for furnishing an incorrect statement in any report or certificate required to be submitted by him under the Act are as below:

Under Section 278: "If a person abets or induces in any manner another person to make and deliver an account or a statement or declaration relating to any income [or any fringe benefits] chargeable to tax which is false and which he either knows to be false or does not believe to be true or to commit an offence under sub-section (1) of section 276C, he shall be punishable,-

Section 278 of the Income Tax Act, 1961:

- (i) in a case where the amount of **tax, penalty or interest** which would have been evaded, if the declaration, account or statement had been accepted as true, or which is willfully attempted to be evaded, **exceeds [twenty five] hundred thousand rupees, with rigorous imprisonment** for a term which shall not be less than **six months but which may extend to seven years and with fine;**
- (ii) **in any other case, with rigorous imprisonment** for a term which shall not be less than **three months but which may extend to [two] yeas and with fine**

Under Rule 12A of the Income Tax Rules: Under this rule a Chartered Accountant who as an authorised representative has prepared the return filed by the assessee, has to furnish to the Assessing Officer, the particulars of accounts, statements and other documents supplied to him by the assessee for the preparation of the return.

Where the Chartered Accountant has conducted an examination of such records, he has also to submit a report on the scope and results of such examination. The report to be submitted will be a statement within the meaning of Section 277 of the Income Tax Act. Thus, **if this report contains any information which is false** and which the Chartered Accountant either knows or believes to be false or untrue, he would be liable to **rigorous imprisonment which may extend to seven years and to a fine.**

Under Section 271J of the Income Tax Act: As per new section inserted by the Finance Act, 2017 if an accountant or a merchant banker or a registered valuer, **furnishes incorrect information in a report or certificate** under any provisions of the Act or the rules made there under, the Assessing Officer or the Commissioner (Appeals) may direct him to pay a sum of **ten thousand rupees** for each such report or certificate by way of penalty. [Section 271J]

Question 7

State the nature of liability as provided in the Companies Act, 2013 of an auditor for not appropriately dealing with a misstatement appearing in audited financial statements or a false

statement in Audit Report.

Answer

Nature of Liability as per the Companies Act, 2013:- Under section 448 of the Companies Act, 2013, an auditor is **liable for criminal prosecution**, if he, in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, **makes a statement (a) which is false** in any material particular knowing it to be false; or (b) **which omits any material fact** knowing it to be material.

If convicted, he can be **punished** with imprisonment and also with fine as provided **under section 447** of the said Act.

Thus, **in view of above, an auditor will be held liable for criminal prosecution** for not appropriately dealing with a misstatement appearing in audited financial statements or a false statement in Audit Report assuming that it was known to auditor.

Question 8

CA Prince, a Chartered Accountant has appeared before the Income Tax Authorities as the authorized representative of his client and delivers to the Income Tax Authorities a false declaration. What are the liabilities of CA. Prince under Income Tax Act, 1961?

Answer

False Declaration as Authorized Representative: In connection with proceedings under the Income Tax Act 1961, a **Chartered Accountant often acts as the authorised representative** of his clients and attends before an Income Tax Authority or the appellate tribunal.

Any person who **acts or induces**, in any manner **another person to make and deliver to the Income Tax Authorities a false account, statement, or declaration**, relating to any income chargeable to tax which he knows to be false or does not believe to be true will be **liable under section 278 of the Income Tax Act 1961**.

Further, in case of submission of any information which is false and which the Chartered Accountant either knows or believes to be false or untrue, he would be **liable to rigorous imprisonment which may extend to seven years (in other cases two years) and/or to a fine**.

In the instant case, Mr. Prince, a chartered accountant has appeared before the Income Tax Authorities as the authorized representative of his client and delivered a false declaration, **thus, he would be liable under section 278 of the Income Tax Act, 1961**.

Chapter 15

Internal Audit, Management & Operational Audit

Question 1

JKT Pvt. Ltd. having ₹ 40 lacs paid up capital, ₹ 9.50 crores reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 49 crores, ₹ 145 crores and ₹ 260 crores, but does not have any internal audit system. In view of the management, internal audit system is not mandatory. Comment.

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of Companies (Audit and Auditors) Rules, 2014 every **private company** shall be required to appoint an internal auditor or a firm of internal auditors, having-

- (i) **turnover of two hundred crore rupees or more during preceding financial year; or**
- (ii) **outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during preceding financial year:**

In the instant case, JKT Pvt. Ltd. is having turnover of ₹ 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit.

Question 2

WWF Ltd. is a public company having ₹ 40 lacs paid up capital in previous financial year which raised to ₹ 60 lacs in current financial year under audit. The company had turnover of previous three consecutive financial years being ₹ 49 crores, ₹ 145 crores and ₹ 150 crores. During the previous year, WWF Ltd. borrowed a loan from a public financial institution of ₹ 110 crores but squared up ₹ 20 crores by the year end. The company does not have any internal audit system. In view of the management, internal audit system is not mandatory.

You are required to state the provisions related to applicability of internal audit as per the Companies Act, 2013 and comment upon the contention of the management of the company.

Answer

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

- (A) every **listed company**;
- (B) every **unlisted public company** having-
 - (1) **paid up share capital of fifty crore rupees or more** during the preceding financial year; or
 - (2) **turnover of two hundred crore rupees or more** during the preceding financial year; or
 - (3) **outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more** at any point of time during the preceding financial year; or
 - (4) **outstanding deposits of twenty five crore rupees or more** at any point of time

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during the preceding financial year; and

(C) every **private company** having-

- (1) **turnover of two hundred crore rupees or more** during the preceding financial year; or
- (2) **outstanding loans** or borrowings from banks or public financial institutions **exceeding one hundred crore rupees or more** at any point of time during the preceding financial year.

In the given case, WWF Ltd. is a public company. The company borrowed a loan from a public financial institution of ₹ 110 crores during the previous year. At the year end, the loan outstanding after being squared up is ₹ 90 crores (₹ 110 crores - ₹ 20 crores) which is less than the minimum prescribed limit of ₹ 100 crores for applicability of internal audit. Although, the outstanding loan at previous year end is ₹ 90, it was ₹ 110 crores at some point of time which is the requirement of the section (refer Rule 13(B)(3) as mentioned above).

Hence, WWF Ltd. has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit. Consequently, the contention of the management of the company is not tenable.

Question 3

AB Pvt. Ltd. company having outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint internal auditor. Please guide him for applicability of the same and who can be appointed as internal auditor and what work would be reviewed by him.

Answer

Applicability of Internal Audit: Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if its **outstanding loans** or borrowings from banks or public financial institutions **exceeding one hundred crore rupees or more** at any point of time during the preceding financial year.

In view of above provisions, AB Pvt. Ltd. is under compulsion to conduct internal audit as its loans or borrowings are falling under the prescribed limit.

Who can be appointed as Internal Auditor- The internal auditor shall **either be a chartered accountant or a cost accountant, whether engaged in practice or not, or such other professional as may be decided by the Board** to conduct internal audit of the functions and activities of the companies.

The internal auditor **may or may not be an employee of the company.**

Work to be reviewed by Internal Auditor-

- Review of **Internal Control System** and Procedures
- Review of Custodianship and **Safeguarding of Assets**
- Review of **Compliance with Policies, Plans, Procedures and Regulations**
- Review of Relevance and **Reliability of Information**
- Review of the **Organisation Structure**
- Review of **Utilisation of Resources**
- Review of **Accomplishment of Goals and Objectives**

Question 4

The Managing Director of X Ltd is concerned about high employee attrition rate in his company.

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As the internal auditor of the company he requests you to analyze the causes for the same. What factors would you consider in such analysis?

Answer

The factors responsible for high employee attrition rate are as under:

- (i) **Job Stress** & work life imbalance
- (ii) **Wrong policies** of the Management
- (iii) **Unbearable behaviour** of Senior Staff
- (iv) **Safety factors**
- (v) **Limited opportunities for promotion**
- (vi) **Low monetary benefits**
- (vii) **Lack of labour welfare schemes**
- (viii) Whether the organization has properly **qualified and experienced personnel** for the various levels of works?
- (ix) Is the number of **people employed** at various work centres **excessive or inadequate**?
- (x) Does the organization provide facilities for **staff training** so that employees and workers keep themselves abreast of current techniques and practices?

Question 5

Webcom Ltd, a public company with a paid-up share capital of ₹ 20 crores has a turnover for the financial year 2020-21 of ₹ 220 crores. X, a recently qualified Chartered Accountant, has been appointed for conducting internal audit. He seeks your advice in drafting a good quality internal audit report. Please guide him by elaborating (in brief) the essential features of a good internal audit report.

Answer

Essential features of a good internal audit report: The contents of an internal audit report are influenced by various factors such as the nature of internal auditing function in the organisation, level of reporting, degree of management support and capabilities of internal audit staff. However, for preparing a good internal audit report, the following general rules may be observed.

- (i) **Objectivity** - To maintain the credibility of internal audit function the comments and opinions expressed in the report should be as objective and unbiased as possible.
- (ii) **Clarity** - The language used should be simple and straight-forward. As far as practicable use of technical terms and jargon should be avoided. Each draft of the report should be reviewed by a senior who should attempt to read it from the point of view of the users of the report.
- (iii) **Accuracy** - The information contained in the report, whether quantified or otherwise, should be accurate. Where approximation or assumptions have been made the fact should be clearly stated along with reasons, if material.
- (iv) **Conciseness** - Brevity is vital subject, of course, to the condition that important information should not be omitted.
- (v) **Constructiveness** - Destructive criticism should carefully be avoided in the report. The report should clearly demonstrate that the internal auditor is trying to assist the auditor in

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an effective discharge of his responsibilities.

- (vi) **Readability** - The reader's interest should be captured and retained throughout. For this, appropriate paragraph heading may be used.
- (vii) **Timeliness** - The report should be submitted promptly because if the time lag between the occurrence of an event and its reporting is considerable, the opportunity for taking action may be lost or a wrong decision may be taken in the absence of the information.
- (viii) **Findings and conclusions** - These may be given either department-wise or in the order of importance. All the facts and data pertaining to the situation should be assembled, classified and analysed. Each conclusion and opinion should normally follow the findings. Tables or graphs may be used for the presentation of statistical data in appendices.
- (ix) **Recommendations** - An internal audit report usually includes recommendations for potential improvements. In order to enable the management to accept and implement the recommendations, the internal auditor should be able to convince the management that the conclusions are logical and valid and the recommendations represent effective and feasible ways of taking action.
- (x) **Auditee's views** - The auditee's views about audit conclusions or recommendations may also be included in the audit report in appropriate circumstances.
- (xi) **Summary** - A summary of conclusions and recommendations may be given at the end. This is particularly useful in long reports.
- (xii) **Supporting information** - The internal auditor should supplement his report by such documents and data which adequately and convincingly support the conclusions. Supporting information may include the relevant standards or regulations.
- (xiii) **Draft Report** - Before writing the final report, the internal auditor should prepare a draft report. This would help him in finding out the most effective manner of presenting his reports. It would also indicate whether there is any superfluous information or a gap in reasoning.
- (xiv) **Writing and issuing the Final Report** - The final report should be written only when the auditor is completely satisfied with the draft report. The head of the internal auditing department, may review and approve the final report. Before issuing the final report, the auditor should discuss conclusions and recommendations at appropriate levels of management. The report should be duly signed.

Question 6

State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function.

Answer

Evaluation of Internal Audit Functions by External Auditor: The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:

- (a) **Organisational Status** - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation his reports to the highest level of management and is free of any other operating responsibility. Any **constraints or restrictions** placed upon his work by management should be carefully evaluated. In particular, the internal auditor

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should be free to communicate fully with the external auditor.

- (b) **Scope of Function** - The external auditor should ascertain the **nature and depth of coverage of the assignment** which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.
- (c) **Technical Competence** - The external auditor should ascertain that internal audit work is performed by persons having **adequate technical training and proficiency**. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
- (d) **Due Professional Care** - The external auditor should ascertain whether internal audit work appears to be **properly planned, supervised, reviewed and documented**. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.

Question 7

OPQ Ltd is in the business of software consultancy. The company has had large balances of accounts receivables in the past years which have been assessed as area of high risk. For the year ended 31 March 2021, in respect of the valuation of accounts receivable, the statutory auditor has assigned the checking of the accuracy of the aging of the accounts receivables and provision based on ageing to the internal auditor providing direct assistance to him. Please advise.

Answer

As per SA 610 Using the Work of Internal Auditor, the **external auditor (Statutory Auditor) shall not use internal auditors to provide direct assistance to perform procedures that:**

- (a) **Involve making significant judgments** in the audit;
- (b) Relate to **higher assessed risks of material misstatement** where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;
- (c) Relate to **work with which the internal auditors have been involved** and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- (d) Relate to **decisions the external auditor makes** in accordance with this SA **regarding the internal audit function** and the use of its work or direct assistance.

In the given case where the valuation of accounts receivable is assessed as an area of higher risk, the statutory auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

Question 8

Mr. Anand is appointed as statutory auditor of XYZ Ltd. XYZ Ltd is required to appoint internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. Bhola as its internal auditor. The external auditor Mr. Anand asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.

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- (a) Discuss whether Mr. Anand, statutory auditor, can ask direct assistance from Mr. Bhola, internal auditor as stated above in view of Standards on Auditing.
- (b) Will your answer be different, if Mr. Anand ask direct assistance from Mr. Bhola, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?

Answer

- (a) **Direct Assistance from Internal Auditor:** As per SA 610 "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that **involve making significant judgments** in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the **risks of material misstatement**;
- Evaluating the **sufficiency of tests** performed;
- Evaluating the appropriateness of **management's use of going concern** assumption;
- Evaluating **significant accounting estimates**; and
- Evaluating the **adequacy of disclosures** in the financial statements, and other matters affecting the auditor's report.

In view of above, **Mr. Anand cannot ask direct assistance** from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

- (b) **Direct Assistance from Internal Auditor in case of External Confirmation Procedures:** SA 610 "Using the Work of Internal Auditor", provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Further, in accordance with **SA 505, "External Confirmation"** the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, **it would not be appropriate to assign these responsibilities to internal auditors.** However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

Question 9

Moon Ltd. of which you are the Statutory Auditor, have an internal audit being conducted by an outside agency. State the factors that weigh considerations in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit.

Answer

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance: SA 610 'Using the work of Internal Auditor' Deals about the concept of direct assistance of internal auditor. In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

- (1) The **amount of judgment** involved in:

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- (i) Planning and performing **relevant audit procedures**; and
 - (ii) Evaluating the **audit evidence** gathered;
- (2) The assessed **risk of material misstatement**; and
- (3) The external auditor's evaluation of the **existence and significance of threats to the objectivity and level of competence** of the internal auditors who will be providing such assistance.

If using internal auditors to provide direct assistance is **not prohibited by law or regulation**, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance.

The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include **inquiry of the internal auditors regarding interests and relationships** that may create a threat to their objectivity.

Question 10

Internal auditor makes an appraisal of organization structure to ensure that it is in harmony with the objectives of the entity, besides checking of financial transactions and operational activities of the entity- Elaborate.

Answer

Review of the Organisation Structure - The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in **harmony with the objectives** of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:

- He should **review the manner in which the activities of the enterprise are grouped for managerial control**. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.
- The internal auditor should **examine the organization chart** to find out whether **structure is simple and economical** and that no function enjoys an undue dominance over the others.
- He should particularly see that the **responsibilities of managerial staff** at headquarters **do not overlap with those of chief executives** at operating units. He should examine whether there is a satisfactory balance between authority and responsibility of important executives.
- The internal auditor should examine the **reasonableness of the span of control** of each executive (the number of sub-ordinates that an executive controls). He should examine whether there is a **unity of command** i.e., whether each person reports only to one superior.
- Where **dual responsibilities** cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.
- Finally, he should **evaluate the process of managerial development** in the enterprise. This is a vital aspect in a fast growing enterprise.

Question 11

Write a short note on general objectives of an operational audit.

Answer

General objectives of operational audit: It includes-

- (i) Appraisal of Controls.

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- (ii) Evaluation of performance.
- (iii) Appraisal of objectives and plans and
- (iv) Appraisal of organizational structure.
- (i) **Appraisal of controls:** Operations and the results in which management is interested are largely a matter of control. If controls are effective in design and are faithfully adhered to the result that can be attained then they will be subject to the **other limiting constraints** in the organization.
- (ii) **Evaluation of performance:** In the task of performance evaluation, an operational auditor is heavily dependent upon availability of **acceptable standards**. The operational auditor cannot be expected to possess technical background in so many diverse technical fields obtaining even in one enterprise. Even when examining or appraising performance or reports of performance the operational auditor's mind is invariably fixed on control aspects.
- (iii) **Appraisal of objectives and plans:** In performance appraisal, the operational auditor is basically concerned not so much with how well technically the operations are going on, but with accumulating information and evidence to **measure the effectiveness, efficiency and economy** with which the operations are being carried on.
- (iv) **Appraisal of organisational structure:** Organisational structure provides the line of relationships and delegation of authority and tasks. This is an important element of the internal control design. In evaluating organisational structure, the operational auditor should consider whether the **structure is in conformity with the management objectives** and it is drawn up on the basis of matching of responsibility and authority. He should also analyse whether line of responsibility has been fixed, whether delegation of responsibility or authority is clear and there is no overlapping area.

Question 12

Employees of GIG Ltd. have to travel frequently for business purposes, so the company entered into a contract with a Simony Travels Ltd. for managing booking, cancellation and other services required by their employees. As per contract terms, Simony travels has to raise its monthly bills for the tickets booked or cancelled during the period and the same are paid by GIG Ltd. within 15 days of the bill date. The bills raised by Simony travels were of huge amount, so the management of GIG Ltd. decided to get an audit conducted of the process followed for booking/cancellation of tickets and verify the accuracy of bills raised by travel agency. Which audit do you feel the management should opt for? Also briefly discuss the qualities the auditor should possess for such audit.

Answer

Operational audit, (functional audit) as it is the audit for the management and involves verifying the effectiveness, efficiency and economy of operations done by the Simony travels for the organisation.

The operational auditor should possess **some very essential personal qualities** to be effective in his work:

1. In areas beyond accounting and finance, his knowledge ordinarily would be rather scanty and this is a reason which should make him even **more inquisitive**.
2. He should ask the who, why, how of everything. He should try to visualise whether **simpler alternative means** are available to do a particular work.
3. He should try to see everything as to whether that properly fits in the business frame and

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organisational policy. He should be **persistent and** should possess an **attitude of skepticism**.

4. He should **not give up or feel satisfied easily**. He should imbibe a **constructive approach rather than a fault-finding approach** and should give a feeling that his efforts are to help attaining an improved operation and not merely fault finding.
5. If the auditor succeeds in giving a **feeling of help and assistance** through constructive criticism, he will be able to obtain co-operation of the persons who are involved in the operations. This will itself be a tremendous achievement of the operational auditor. He should **try to develop a team** comprised of people of different backgrounds. Involvement of technical people in operational auditing is generally helpful.

Question 13

The Operational Audit is carried out effectively when the Operational Auditor responds with positive traits in a scenario which is blended with behavioural issues. Explain few positive traits that help to conclude an Operational Audit, a success.

Answer

Positive Traits that help to conclude an Operation Audit A success: The operational auditor should possess some very essential personal qualities to be effective in his work:

In areas beyond accounting and finance, his knowledge ordinarily would be rather scanty and this is a reason which should make him even **more inquisitive**.

He should ask the who, why, how of everything. He should try to visualise whether **simpler alternative means** are available to do a particular work.

He should try to see everything as to whether that properly fits in the business frame and organisational policy. He should be **persistent and** should possess an **attitude of skepticism**.

He should **not give up or feel satisfied easily**. He should imbibe a **constructive approach rather than a fault-finding approach** and should give a feeling that his efforts are to help attaining an improved operation and not merely fault finding.

If the auditor succeeds in giving a **feeling of help and assistance** through constructive criticism, he will be able to obtain co-operation of the persons who are involved in the operations. This will itself be a tremendous achievement of the operational auditor. He should **try to develop a team** comprised of people of different backgrounds. Involvement of technical people in operational auditing is generally helpful.

Question 14

DLF Ltd., a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.

Answer

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

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

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

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

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

Question 15

Many modern enterprises have become huge and sophisticated. This has resulted in decentralisation of their activities and different type of audits. You are required to explain the difference to the management:

- (a) Internal & Operational Audit.
- (b) Management Audit & Operational Audit.
- (c) Financial Audit & Operational Audit.

Answer

- (a) **Difference between Internal & Operational Audit:** There probably may not be much of difference in viewing operational audit as a review and appraisal of operations of an organisation carried on by a competent independent person. Auditing whether carried on by an internal staff or by an external person, should necessarily be an independent activity to maintain its objectivity and usefulness.

The difference in the approach of both these audits is illustrated below:

1. **Perception** - Traditionally, internal auditors have been engaged in a sort of protective function, deriving their authority from the management. They view and examine internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they check the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable.

For example - when the auditor looks into the vouchers to see whether they corroborate the entries in the cash book or physically examines the cash in hand he is doing his traditional protective function. The moment he concerns himself to see whether customers' complaints are duly attended to or whether cash balance is excessive to the need, he comes to the operational field.

Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would be interested in such matters as reorder policy, obsolescence policy and the overall inventory management policy. In pure administrative areas on stock, he will see

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whether adequate security and insurance arrangements exist for protection of stocks.

2. **Issues** - The basic difference that exists in conceptualisation of the technique of operational auditing is in the auditor's role in recommending corrections or in installing systems and controls. According to Lindberg and Cohn, such a situation would be in conflict with the role of operational auditor. In this connection, the views of the Institute of Internal Auditors, in the context of internal audit are relevant. According to that Institute, "the internal auditor should be free to review and appraise policies, plans, procedures and records; but his review and appraisal does not in any way relieve other persons in the organisation of the responsibilities assigned to them.

However, a further distinction should be observed between traditional internal auditing and operational auditing - this lies in the attitude and approach to the whole auditing proposition. Every aspect of operational auditing programme should be geared to management policies, management objectives and management goals.

3. **Objectives** - The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems and prospects and its environment.

Above all, his mind should be open and active so as to be able to perceive problems and prospects and grasp technical matters. In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues. The norms and standards should be such as are generally acceptable or developed by the company itself.

Performance yardsticks can be found in the management objectives, goals and plans, budgets, records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments.

For Example: The standards relating to objectives for a government company are quite different from those of a private sector company. Similarly standards of performance of a well-equipped company which also adequately looks after the well-being of employees may be significantly different from a company which offers scanty welfare facilities or is ill-equipped.

Today, however, the concept of modern internal auditing suggests that there is no difference in internal and operational auditing. In fact, the scope of internal auditing is broad enough to embrace the areas covered by operational auditing as well. The modern internal auditing performs both protective as well as constructive functions.

(b) Difference between Management Audit & Operational Audit

- (i) Management audit is concerned with the "Quality of managing", whereas operational audit focuses on the "Quality of operations".
- (ii) Management audit is the "**Audit of management**" while operational audit is the "**Audit for the management**".
- (iii) The basic difference between the two audits, then, is not in method, but in the level of appraisal. In management audit, the auditor is to make his tests to the level of top management, its formulation of objectives, plans and policies and its decision making. It is not that he just verifies the operations of control and procedures and fulfilment

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of plans in conformity with the prescribed policies.

- (c) **Differences between Financial and Operational Auditing** - 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 but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.
 - (iii) **Reporting** - The financial audit report is sent to all stock holders, bankers and other persons having stake 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 report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also.

Question 16

- (a) Perfect Steel Ltd. has reported a higher turnover of ₹ 560 crores in the year 2020-21 as compared to earlier years but its sales return has also increased to 10% from only 4% upto the last year. The management is concerned about the high sales returns and feels a need to get the operational audit done for sales and production department of the company. The company is also having an internal audit system in the company. Elaborate the possible reason/s, why management is getting operational audit done when internal audit has already been done for both the departments by stating the shortcomings of conventional information sources.
- (b) You are also required to discuss the difference in the approach of both of these audits.

Answer

(a) **Why Operational Audit?:** The need for operational auditing has **arisen due to the inadequacy of traditional sources of information** for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation.

Operational audit is considered as a **specialised management information tool to fill the void that conventional information sources fail to fill**. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the departments all of whose activities do not come under direct observation of managers. The **shortcomings of these sources** can be stated as under:

- (i) Executives and managers are too preoccupied with implementation of plans and achieving of targets. They are left with very little time to collect information and locate problems. They may come across problems that have come to surface but they are hardly aware of problems that are brewing and potential.
- (ii) Managers or their aides are generally **relied upon for transmitting information** than for booking for information or for analysing situations.
- (iii) The information that is transmitted by managers is not necessarily objective - often it may be **biased for various reasons**.

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- (iv) **Conventional internal audit reports are often routine and mechanical in character** and have a definite leaning towards accounting and financial information. They are also historical in nature.
- (v) **Other performance reports** contained in the annual audited accounts and the routine reports prepared by the operating departments **have their own limitations**.

The annual audited accounts are good as far as an overall evaluation is concerned in monetary terms.

Example: Sales may be shown at a higher monetary value compared to the previous year and this may apparently suggest that the functioning of the sales department is satisfactory. But this may have been caused by a number of factors in spite of a really bad performance on the sales front. This fact may not be readily known unless one cares to analyse the sales data by reference to notes and explanations to the accounts and other related accounting data. Even a study of this nature may not fully reveal the weakness. It is quite possible that the established market for sales has been lost partly while some fortuitous sales have compensated the loss

Example: The routine weekly production report may include production 'that is subsequently rejected by the quality control staff, or to avoid showing a bad production performance; even the partly produced goods may also be included. Remember, all this can happen in spite of specific management instructions about the basis on which the production report is to be made out.

Another important point may be noticed in the matter of routine departmental reports. The busy management people, who can afford time only to glance over the performance reports, cannot be expected to make an integrated reading of several reports or to undertake an analysis of such reports. What they need is reliable, unmanipulated and objective report which they would like to look into to understand the situation.

- (vi) **Operations of controls** in a satisfactory manner **cannot be relied upon** to bring to light the environmental conditions. Controls are specific and their satisfactory operation is related to the specific situation under control. Also monitoring of the breakdown or non-operation of controls is a periodic phenomenon.
- (vii) **Surveys and special investigations**, no doubt, are very useful but these are at the best **occasional in character**. Also, they are **costly, time consuming** and keep the departmental key personnel busy during the period they are on. These are basically an attempt to carry out a post-mortem rather than to enlighten the management about the ways on improvement or for better performance or to give a signal for dangers and disasters to come.

(b) The difference in the approach of both of these audits is illustrated below:

1. **Perception** - Traditionally, internal auditors have been engaged in a sort of protective function, deriving their authority from the management. They view and examine internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they check the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable.

For example - when the auditor looks into the vouchers to see whether they corroborate the entries in the cash book or physically examines the cash in hand he is doing his traditional protective function. The moment he concerns himself to see whether customers' complaints are duly attended to or whether cash balance is excessive to the need, he comes to the operational field.

Also, he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would be

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interested in such matters as reorder policy, obsolescence policy and the overall inventory management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

- 2. Issues** - The basic difference that exists in conceptualisation of the technique of operational auditing is in the auditor's role in recommending corrections or in installing systems and controls. According to Lindberg and Cohn, such a situation would be in conflict with the role of operational auditor. In this connection, the views of the Institute of Internal Auditors, in the context of internal audit are relevant. According to that Institute, "the internal auditor should be free to review and appraise policies, plans, procedures and records; but his review and appraisal does not in any way relieve other persons in the organisation of the responsibilities assigned to them.

However, a further distinction should be observed between traditional internal auditing and operational auditing - this lies in the attitude and approach to the whole auditing proposition. Every aspect of operational auditing programme should be geared to management policies, management objectives and management goals.

- 3. Objectives** - The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems and prospects and its environment.

Above all, his mind should be open and active so as to be able to perceive problems and prospects and grasp technical matters. In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues. The norms and standards should be such as are generally acceptable or developed by the company itself.

Performance yardsticks can be found in the management objectives, goals and plans, budgets, records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments.

For example - The standards relating to objectives for a government company are quite different from those of a private sector company. Similarly, standards of performance of a well-equipped company which also adequately looks after the well-being of employees may be significantly different from a company which offers scanty welfare facilities or is ill-equipped.

Today, however, the concept of modern internal auditing suggests that there is no difference in internal and operational auditing. In fact, the scope of internal auditing is broad enough to embrace the areas covered by operational auditing as well. The modern internal auditing performs both protective as well as constructive functions.

Question 17

Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them.

Answer

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Behavioural Aspects Encountered in Management Audit: Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are **many causes for behavioural problems** arising in the review function of management audit. Particularly, when management auditors perform comprehensive audit of operations, they cannot be as well informed about such operations as a financial auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below:

- (1) **Staff / Line conflict:** Management auditors are staff people while the members of other departments are line people. Management auditors **tend to discount the difficulties** the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.
- (2) **Control:** The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are as under:
 - (i) Fear of **criticism stemming** from adverse audit findings.
 - (ii) Fear of **change in day to day working habits** because of changes resulting from audit recommendations.
 - (iii) **Punitive action by superior** prompted by reported deficiencies.
 - (iv) **Insensitive audit practices.**
 - (v) **Hostile audit style.**

Solution to behavioural problems: The following steps may be taken to overcome the aforesaid problems-

- (i) To demonstrate that audit is part of an **overall programme of review** for protective and constructive benefit.
- (ii) To demonstrate the objective of review is to **provide maximum service** in all feasible managerial dimensions.
- (iii) To demonstrate the review will be with **minimum interference with regular operation.**
- (iv) The **responsible officers will be involved in the process of review** of the findings and recommendations before the audit report is formally released.

It is essential to **create an atmosphere of trust and friendliness** so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the **right calibre**. May be to expect a combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

Question 18

Write a short note on-Summary Written Report.

Answer

Summary reports are also referred to as '**flash**' reports'. In a number of companies the practice has developed of issuing an annual (or sometimes more frequent) report **summarising the various individual reports** issued, and describing the range of their content. These summary reports in some cases are **primarily for audit committees of Boards of Directors**, but in other cases for higher level management. They are especially useful to top level managers who do not actively review the individual reports. They are **also useful to the general auditor** in seeing his total reporting effort with more perspective and on an integrated basis.

Question 19

What are the Management Audit Questionnaires?

Answer

Management Audit Questionnaire: A management audit questionnaire is an **important tool for conducting the management audit**. It is through these questionnaires that the auditors make an **inquiry into important facts** by measuring current performance. Such questionnaires aim at a **comprehensive and constructive examination of an organisation's management** and its assigned tasks. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives. Its **primary objective is to highlight weaknesses and deficiencies of the organisation**. It includes a review of how well or badly the management functions of planning, organising, directing and controlling are being performed. The questionnaire provides a means for evaluating an organisation's ongoing operations by examining its major functional areas. There are **three possible answers to the management audit questions: "Yes", "No" and "N.A."**, (not applicable). Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action. The management audit questionnaire **does not give answers, but simply asks questions**. If all questions are answered with a 'yes', operations are proceeding as desired. On the other hand, if there are one or more 'no' answers, difficulties are being experienced and must be explained in writing. If the question does not apply, the N.A. (not applicable) column is checked. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to **synthesis those elements that are causing organisational difficulties and deficiencies**.

Question 20

M/s ABC & Co., Chartered Accountants have been approached by PQR Ltd., a company engaged in iron and steel manufacturing industry. The company has been facing following operational issues:

- (a) Penal interest for delayed payments to the overseas vendors despite having enough cash flows; and
- (b) Despite having regular production and enough inventory, delays in shipping the final goods to the customers leading to its deteriorating vendor rating.

As a partner of M/s ABC & Co., through detailed discussion with the Senior Manager of PQR Ltd.,

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you have concluded that all these delays are because of long decision-making cycles in the company. As a consultant to the Company, would you recommend Management Audit or Operational Audit?

Answer

A comparison between the Management Audit & the Operational Audit is as follows:

Management audit is concerned with the “**Quality of managing**”, whereas operational audit focuses on the “**Quality of operations**”.

Management audit is the “**Audit of management**” while the operational audit is the “**Audit for the management**”. The focus of Management Audit is on “**Quality of Decision Making**” rather than the effectiveness or efficiency of operations.

The **basic difference between the two audits, then, is not in method, but in the level of appraisal**. In a management audit, the auditor is to **make his tests to the level of top management**, its formulation of objectives, plans and policies and its decision making. **It is not that he just verifies the operations of control and procedures** and fulfillment of plans in conformity with the prescribed policies.

Since, the delays in payments and consequent penal interest payments and the delays in shipping and the consequent deteriorating vendor ratings are happening because of the delays in decision-making process of the management. **Therefore, it appears that this is not just an internal control or operational issue but an issue of management process.**

Therefore, management audit would be recommended in this case.

Question 21

The PQR Ltd. has come across many instances where it could buy products at lesser cost than the actual procurement price it paid. The management believes that the adequate purchase policy is in place including the requirements of three quotations from registered vendors, appropriate vendor vetting and rating mechanism, however, the on-ground implementation of the purchase policy might be defective. Further, it has observed that there might be some employees involved in choosing the higher cost vendors as well. The company approaches you to advise the type of audit it should get done: Management or Operational. Please advise through a comparison between both the audits.

Answer

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Since it is not the Management's Decisions that are creating the operational bottlenecks. The Purchase Policy and Procedure seem to be in place, the **missing part is the operational implementation** by the process employees. **Therefore, the Operational Audit is recommended in this case.**

Question 22

The Marketing Department of XYZ Ltd. has been consistently showing a lower performance whereas cost of the department is increasing in spurts over the years. The management believes that since the marketing department is under a regular radar of the CFO, an audit might result in the employee hostility. Also, an operational audit of Marketing Department was done two years back however, the recommendations of the previous audit were not followed by the concerned employees. Please advise the management if another audit is the solution and whether only one-time operational audit is enough? Further, advise on the ways to deal with employee hostility.

Answer

The Operational Audit is not one-time activity. It should be viewed as a continuous improvement cycle. **The continuous improvement cycle of Operational Audit can be depicted through Plan, Do, Check and Act diagram.**

All the significant operations must be subjected to the **scrutiny** of operational audit, **at least, once in three years.** Therefore, the operational audit should be done in the current scenario. However, to deal with the employee hostility the **participative approach** of the audit should be adopted:

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

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

Question 23

What are the types of Operational Audits?

Answer

Type of Operational Audits: There are three broad categories of operational auditors: functional, organizational, and special assignments. In case, part of the audit is likely to concern evaluating internal controls for efficiency and effectiveness.

- (i) **Functional Audits** - Functions are a means of **categorizing the activities of a business**, such as the billing function or production function. There are **many different ways to**

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categorize and subdivide functions. For example, there is an **accounting function**, but there are also cash disbursements, cash receipt, and **payroll disbursement functions**. There is a payroll function, but there are also hiring, timekeeping, and payroll disbursement functions. As the name implies, a functional audit deals with one or more functions in an organization. It could concern, for example, the payroll function for a division or for the company as a whole.

A functional audit has the **advantage of permitting specialization by auditors**. Certain auditors within an internal audit staff can develop considerable expertise in an area, such as production engineering. They can more efficiently spend all their time auditing in that area. A disadvantage of functional auditing is the failure to evaluate interrelated functions. The production engineering function interacts with manufacturing and other functions in an organization.

- (ii) **Organizational Audits** - An operational audit of an **organization deals with an entire organizational units, such as a department, branch, or subsidiary**. An organizational audit emphasizes **how efficiently and effectively functions interact**. The plan of organization and the methods to coordinate activities are especially important in this type of audit.
- (iii) **Special Assignments** - In operational auditing, **special assignments arise at the request of management**. There are a wide variety of such audits. **Examples include determining the cause of an ineffective IT system, investigating the possibility of fraud** in a division, and making recommendations for reducing the cost of a manufactured product.

Question 24

In evaluating the organizational structure of a company, what aspects may be considered by the operational auditor to achieve his objectives?

Answer

Aspects to be considered by Operational Auditor in evaluating Organisational Structure:

Organisational structure **provides the line of relationships and delegation of authority and tasks**. This is an important element of the internal control design. Therefore, this is also another important area for appraisal by the operational auditor.

In evaluating organisational structure, the **aspects that may be considered** by the operational auditor may be as follows:

- (i) Is the organisational structure in **conformity with management objectives**?
- (ii) Whether the organisational structure is drawn up on the basis of **matching of responsibility and authority**?
- (iii) Whether the **line of responsibility from the top to the bottom is clearly discernible** from the structure?
- (iv) Whether the delegation of responsibility and authority at each stage is clear and **overlapping are avoided**?

Chapter 16

Due Diligence, Investigation & Forensic Audit

Unit I – Due Diligence

Question 1

Beta Ltd. is anticipating taking over a manufacturing concern and appoints you for due diligence review. While reviewing, it requests you to look specifically for any hidden liabilities and overvalued assets. State in brief the major areas you would examine for hidden liabilities and overvalued assets.

Answer

Major areas to examine in course of Due Diligence Review: 'Due Diligence' is a term that is often heard in the corporate world these days in relation to corporate restructuring. The purpose of due diligence is to assist the purchaser or the investor in finding out all he can, reasonably about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

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

However, in order to investigate **hidden liabilities**, the auditor should pay his attention to the following areas:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given “**Letters of Comfort**” to banks and Financial Institutions. Since these are not “guarantees”, these may not be disclosed in the Balance sheet of the target company.
- The Company may have **sold some subsidiaries/businesses** and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- **Product and other liability claims**; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- **Tax liabilities** under direct and indirect taxes.
- Long pending sales tax assessments.
- **Pending final assessments** of customs duty where provisional assessment only has been completed.
- **Agreement to buy back shares sold** at a stated price.
- **Future lease liabilities.**
- **Environmental problems/claims/third party claims.**
- Unfunded gratuity/superannuation/leave salary liabilities; **incorrect gratuity valuations.**
- Huge **labour claims** under negotiation when labour wage agreement has already expired.

- **Contingent liabilities** not shown in books.

Regularly Overvalued Assets:

The auditor shall have to specifically examine the following areas:

- Uncollected/**uncollectable receivables**.
- Obsolete, slow **non-moving inventories** or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or **obsolete Plant and Machinery** and their spares; asset values which have been impaired due to sudden fall in market value etc.
- **Assets carried at much more than current market value** due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- **Litigated assets** and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- **Infructuous project expenditure**/deferred revenue expenditure etc.
- **Group Company balances** under reconciliation etc.
- **Intangibles of no value**.

Question 2

KDK Bank Ltd., received an application from a pharmaceutical company for takeover of their outstanding term loans secured on its assets, availed from and outstanding with a nationalised bank. KDK Bank Ltd., requires you to make a due diligence audit in the areas of assets of pharmaceutical company especially with reference to valuation aspect of assets. State what may be your areas of analysis in order to ensure that the assets are not stated at overvalued amounts.

Answer

Over-Valued Assets: In case of due diligence exercise, the area of analysis in order to ensure that the assets are not stated at over-valued amounts are:

- Uncollected/**uncollectable receivables**.
- Obsolete, slow **non-moving inventories** or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or **obsolete Plant and Machinery** and their spares; asset values which have been impaired due to sudden fall in market value etc.
- **Assets carried at much more than current market value** due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- **Litigated assets** and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- **Infructuous project expenditure**/deferred revenue expenditure etc.
- **Group Company balances** not reconciled.
- **Intangibles having no reliable value**.

Question 3

Sri Rajan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Ceta Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to Ceta Ltd.?

Answer

The purpose of due diligence is to **assist the purchaser** or the investor **in finding out all the reasonably can about the business** he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

In order to achieve its objective, the due diligence process can include any or all of the following objectives for individual areas of the verification:

- **Brief description** of the history of business
- The **background of promoters**
- **Accounting policies** and practices
- **Management information systems**
- Details of management structure
- **Trading results** both past and the recent past
- **Assets and liabilities** as per latest balance sheet
- **Current status of Income tax assessments** including appeals pending against tax liabilities assessed by tax authority.
- **Cash flow patterns**
- The projection of **future profitability**

If a full fledged financial due diligence is conducted, it would include the following matters, *inter alia*, in its scope:

(a) Brief history of the target and background of its promoter;	(b) Accounting policies;
(c) Review of financial statements;	(d) Taxation;
(e) Cash flow;	(f) Financial Projection;
(g) Management and employees;	(h) Statutory Compliance.

Question 4

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India. It requests you to conduct a “Due Diligence” of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

Answer

The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

Example of Headings of a Due Diligence Report	
◆	Executive Summary
◆	Introduction
◆	Background of Target
◆	Objective of due diligence
◆	Terms of reference and scope of verification
◆	Brief history of the company
◆	Share holding pattern
◆	Observations on the review
◆	Assessment of management structure
◆	Assessment of financial liabilities
◆	Assessment of valuation of assets
◆	Comments on properties, terms of leases, lien and encumbrances.
◆	Assessment of operating results
◆	Assessment of taxation and statutory liabilities
◆	Assessment of possible liabilities on account of litigation and legal proceedings against the company
◆	Assessment of net worth
◆	Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account
◆	SWOT Analysis
◆	Comments on future projections
◆	Status of charges, liens, mortgages, assets and properties of the company
◆	Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities
◆	Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.

Question 5

“Due diligence is different from audit” – Explain the difference between due diligence and audit.

Answer

It needs be underlined that due diligence is different from audit. **Audit is an independent examination and evaluation of the financial statements** on an organization with a view **to express an opinion thereon**. Whereas, **due diligence refers to an examination of a potential investment to confirms all material facts of the prospective business opportunity**. It involves

Due Diligence, Investigation & Forensic Audit

review of financial and non-financial records as deemed relevant and material. Simply put, due diligence aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

Question 6

PB Ltd. entered into a deal with SV Ltd. for buying its business of manufacturing wooden products/goods. PB Ltd. has appointed your firm for conducting due diligence review and they want to know the cash generating abilities of SV Ltd. What points will you check in order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally?

Answer

A **review of historical cash flows** and their pattern would **reflect the cash generating abilities** of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time.

In order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally, one is **required to verify**:

- (a) Is the **company able to honor its commitments** to its trade payables, to the banks, to the government and other stakeholders?
- (b) How well is the **company able to convert its trade receivables and inventories**?
- (c) How well the **Company deploys its funds**?
- (d) Are there any **funds lying idle** or is the company able to **reap maximum benefits** out of the available funds?
- (e) What is the **investment pattern of the company** and are they easily realizable?

Question 7

What are the areas in which Due Diligence can take place?

Or

Write a short note on classification of Due Diligence.

Answer

Areas in which Due Diligence can take place -

- (i) **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.
- (ii) **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.
- (iii) **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 effect of the merger or acquisition.
- (iv) **Information systems due diligence:** It pertains to all computer systems and related

matter of the entity.

- (v) **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.
- (vi) **Environmental due diligence:** It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
- (vii) **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.

Unit II – Investigation

Question 8

General objective of an audit is to find out whether the financial statements show true and fair view. On the other hand, investigation implies systematic, critical and special examination of the records of a business for a specific purpose.

In view of the above, you are required to brief out the difference between Audit and Investigation.

Answer

Etymologically, **auditing and investigation** are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific.

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half- yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind capable of observing, collecting and evaluating facts.	Is governed by Compliance with generally accepted accounting principles, audit procedures and disclosure requirements.

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(viii) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.
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Question 9

What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?

Answer

Steps involved while conducting Investigation on behalf of an Incoming Partner are the following:

(a) Ascertainment of the history of the inception and growth of the firm.
(b) Study of the provisions of the deed of partnership , particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.
(c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.
(d) Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those for pending tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.
(e) Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.
(f) Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence should be studied.
(g) It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in near future.
(h) Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.
(i) Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.
(j) Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.
(k) It would be useful to have a firsthand knowledge about the specialisation, if any, attained by the firm in any of its activities.

- | |
|---|
| (l) Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained. |
| (m) Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms. |
| (n) Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss. |

Question 10

Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

Answer

The objective of such an investigation is to collect such information as would **enable the purchaser to decide whether it is worthwhile to buy the business** and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given are:

- (i) **Reasons for the sale of the business** and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).
- (ii) The **length of lease** under which the premises are held; the prospects of its renewal or extension.
- (iii) The **unexpired period of any patents** owned by the vendors.
- (iv) The **age of the present managerial staff** and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees and those retrenched.
- (v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.
- (vi) The **valuation** that could be placed on **goodwill** to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.

Question 11

ABC nationalised bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in-charge of advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

Decide the points you will cover in your investigation before submitting your report to the General Manager.

Answer

Investigation on Behalf of the Bank for Advances: A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the

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security that would be available to it, if the borrower fails to pay back the loan. On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under mentioned points:

- (i) The **purpose for which the loan is required** and the manner in which the borrower proposes to invest the amount of the loan.
- (ii) The **schedule of repayment of loan submitted by the borrower**, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for payment of loans on the reliability of annual profits and loss on the values of assets mortgaged to them.
- (iii) The **financial standing and reputation** for business integrity enjoyed by directors and officers of the company.
- (iv) Whether the **company is authorised by the Memorandum or the Articles** of Association to borrow money for the purpose for which the loan will be used.
- (v) The **history of growth and development of the company** and its performance during the **past 5 years**.
- (vi) How the **economic position** of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, **the investigating accountant should take the under-mentioned steps:**

- (a) **Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years**, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.
- (b) **Compute the under-mentioned ratios separately** and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:
 - (i) Sales to Average Inventories held.
 - (ii) **Sales to Fixed Assets.**
 - (iii) Equity to Fixed Assets.
 - (iv) **Current Assets to Current Liabilities.**
 - (v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.
 - (vi) Equity to Long Term Loans.
 - (vii) Sales to Book Debts.
 - (viii) **Return on Capital Employed.**
- (c) Enter in a separate part of the statement the **break-up of annual sales product-wise** to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

- (a) **Fixed assets** - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which

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depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

- (b) Inventory** - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

- (c) Trade Receivables, including bills receivable** - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

- (i) debts due in respect of which the period of credit has not expired;
- (ii) debts due within six months; and
- (iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

- (d) Investments** - The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.
- (e) Secured Loans** - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re - payment of a liability should be disclosed.
- (f) Provision of Taxation** - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.
- (g) Other Liabilities** - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.
- (h) Insurance** - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance- cover appears to be adequate, having regard to the value of assets.

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- (i) **Contingent Liabilities** - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.
- (j) The impact on economic position of the company by economic, political and social changes those are likely to take place during the period of loan.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

Question 12

Mr Sharma is reviewing the anti-fraud controls for a construction company. The company has witnessed a few frauds in the past mainly in the nature of material stolen from the sites and fake expense vouchers.

Mr. Sharma is evaluating options for verifying the process to reveal fraud and the corrective action to be taken in such cases. As an expert, you are required to brief Mr. Sharma about the inventory fraud and verification procedure with respect to defalcation of inventory?

Or

MF. Ltd., engaged in the manufacturing of various products in its factory, is concerned with shortage in production and there arose suspicion of inventory fraud. You are appointed by MF Ltd. To evaluate the options for verifying the process to reveal fraud and the corrective action to be taken. As an investigating accountant what will be your areas of verification and the procedure to be followed for verification of defalcation of inventory?

Answer

Inventory frauds - Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

- (i) Employees may simply **remove goods** from the premises.
- (ii) Theft of goods may be concealed by **writing them off as damaged goods**, etc.
- (iii) **Inventory records may be manipulated by employees who** have committed theft so that book quantities tally with the actual quantities of inventories in hand.

Verification Procedure for Defalcation of inventory - Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and despatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of:

- (a) a system of inventory control, and existence of detailed record of the movement of inventory, or
- (b) availability of sufficient data from which such a record can be constructed.

The step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

Defalcations of inventory, sometimes, also are committed by the management, by **diverting a part of production and the consequent shortages in production being adjusted by inflating**

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the wastage in production; similar defalcations of inventories and stores are covered up by **inflating quantities issued for production.** For detecting such shortages, the investigating accountant should take **assistance of an engineer.** For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the **shortage in production has been inflated.**

In this regard, guidance can also be taken from **past records showing the extent of wastage in production** in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent.

The **per hour capacity of the machine** and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

Question 13

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

Answer

Verification of Cash Receipts: On the assumption that some of these may have been diverted before being entered in the books, evidence as regards **income received from different sources should be scrutinised**, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts. **Carbon copies of receipts marked 'duplicate', should be scrutinised** to confirm that they are in fact copies of receipts issued earlier. In addition, by recalling paying-in-slips from the bank the **details of cash deposited** on each day should be compared with those shown in the Cash Book. The **record of sales of scrap** of waste paper that of collection of rents from labourers temporarily accommodated in the company's quarters that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated. **Cash sales should be vouched in detail. Recoveries from customers** and sundry parties should be **checked** with the copies of receipts issued to them; deductions made on account of **cash discounts should be reviewed. All withdrawals from the bank should be checked** by reference to corresponding entries in the bank pass book.

Question 14

J Ltd. is interested in acquiring S Ltd. The valuation of S Ltd. is dependent on future maintainable sales. As the person entrusted to value S Ltd., what factors would you consider in assessing the future maintainable turnover?

Answer

In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

- (i) **Trend:** Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.
- (ii) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.
- (iii) **Political and economic considerations:** Are the policies pursued by the Government

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likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

- (iv) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Question 15

In a Public Limited Company, it is suspected by the Management that there has been embezzlement in supplier's ledger. As an auditor of the Company, you have been asked to investigate the matter. What are the major areas that you would verify in this regard?

Answer

Areas to be verified in case of embezzlement in supplier's ledger: While investigating the matters regarding embezzlement in supplier's ledger, below mentioned areas should be verified.

- (i) The auditor should **verify the adjustments in fictitious or duplicate invoices as purchases** in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.
- (ii) The auditor should **ensure that suppressing the Credit Notes issued by suppliers** and withdrawing the corresponding amounts not claimed by them.
- (iii) The auditor should **check that withdrawing amounts unclaimed by suppliers**, for one reason or another by showing that the same have been paid to them.
- (iv) The auditor should **verify whether purchase invoices are accepted at prices considerably higher than their market prices** and collecting the excess amount, paid in cash, from the suppliers.
- (v) The auditor should **verify the bought journal with reference to entries in the Goods Inward Book and the suppliers' invoices** to confirm that amounts credited to the accounts of suppliers were in respect of goods, which were duly received, and the suppliers' accounts had been credited correctly.
- (vi) The auditor should **request all the suppliers to furnish statements of their accounts** to see whether or not any balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted.

Question 16

XYZ Ltd. has bought a land in Nagpur for setting up a manufacturing unit in the year 2019 at a price of Rs. 10 crores. In the year 2020, one of the directors of company raised suspicion on the price and transactions related to purchase of land. Therefore, an investigation was ordered by the management and PV Associates were appointed to investigate the matter and submit their report accordingly. PV Associates were of the view that they need to take an expert's opinion on the price of land. Whether PV Associates is authorized to take assistance of expert? If yes, what is the

process they need to follow?

Answer

Often an investigator may feel the **necessity of obtaining views and opinions of experts** in various fields to properly conduct the investigation. It would be therefore, **proper for the investigator to get the written general consent of his client**, to refer special matters for views of different experts at the beginning of investigation and he should settle the question of costs for obtaining the views and other related implications.

If PV Associates feels the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation, **they are allowed to do so.**

It would be therefore, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts at the beginning of investigation and he should **settle the question of costs for obtaining the views and other related implications.**

Question 17

Write a short note on Frauds through supplier ledger.

Answer

Frauds through supplier ledger: Fraud through supplier ledger could be made in any of the following ways, which the auditor has to take case of -

- (1) **Adjusting fictitious or duplicate invoices as purchases** in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.
- (2) **Suppressing credit notes issued by suppliers** and withdrawing the corresponding amount not claimed by them.
- (3) **Withdrawing amounts which remain unclaimed** for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
- (4) **Accepting invoices at prices considerably highest than the market price** and collecting the excess claim from the suppliers directly.

Unit III – Forensic Audit

Question 18

Briefly mentioned the forensic audit techniques name.

Answer

Some of the techniques that a forensic auditor may use are listed below:

(I) General Audit Techniques:

- **Testing defenses:** A good initial forensic audit technique is to attempt to circumvent these defenses yourself. The weaknesses you find within the organizations control will most probably guide you down the sea path taken by suspected perpetrators. This technique requires you to attempt to put yourself in the shoes and think like your suspect.

(II) Statistical & Mathematical Techniques:

- **Trend Analysis:** Businesses have cycles and seasons much akin to nature itself. An expense or event within a business that would be analogous to a snowy day in the middle of summer is worth investigating. Careful review of your subject organization's historical norms is necessary in order for you to be able to discern the outlier event should it arise within your investigation.
- **Ratio Analysis:** Another useful fraud detection technique is the calculation of data analysis ratios for key numeric fields. Like financial ratios that give indications of the financial health of a company, data analysis ratios report on the fraud health by identifying possible symptoms of fraud.

(III) Technology based /Digital Forensics Techniques: Every transaction leaves a digital footprint in today's computer-driven society. Close scrutiny of relevant emails, accounting records, phone logs and target hard drives is a requisite facet of any modern forensic audit. Before taking steps such as obtaining data from email etc. the forensic auditor should take appropriate legal advice so that it doesn't amount to invasion of privacy. Digital investigations can become quite complex and require support from trained digital investigators. However, many open-source digital forensics tools are now available to assist you in this phase of the investigation.

(IV) Computer Assisted Auditing Techniques (CAATs): Changing patterns of businesses, regulatory framework, scarcity of resources at auditors' disposal on one side and the ever increasing mountainous data on other hand is making audit a complex process. Use of CAATs is, thus, indispensable to the Auditors and forensic auditors. Computer-assisted audit techniques (CAATs) or computer-assisted audit tools and techniques (CAATTs) are computer programs that the auditors use as part of the audit procedures to process data of audit significance contained in a client's information systems, without depending on him.

(V) Generalised Audit Software (GAS): Generalized Audit Software (GAS) is a class of CAATs that allows auditors to undertake data extraction, querying, manipulation, summarization and analytical tasks. GAS focuses on the fully exploiting the data available in the entity's application systems in the pursuit of audit objectives. GAS support auditors by allowing them to examine the entity's data easily, flexibly, independently and interactively in data based auditing.

Using GAS, an auditor can formulate a range of alternative hypotheses for a particular potential misstatement in the subject matter and then test those hypotheses immediately. "What if" scenarios can be developed with the results and the auditors can examine the

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generated report rapidly. Currently, the latest versions of GAS include the Audit Command Language (ACL), Interactive Data Extraction and Analysis (IDEA) and Panaudit.

(VI) Common Software Tool (CST): Due to shortcomings of GASs, CSTs have become popular over a period. Spreadsheets (like MS Excel, Lotus, etc.), RDBMS (like MS Access, etc.) and Report writers (like Crystal reports, etc.) are few examples of CSTs. Their widespread acceptability is due to its instant availability and lower costs. While spreadsheets may be extremely easy to use due to its simplicity and versatility, other CSTs may need some practice.

Whether one uses GAS or CST, it is imperative that the auditor is aware about the manner and processes that have led to the data generation, the control environment revolving around the data and the source from where the data samples are imported into the GAS/CST.

(VII) Data Mining Techniques: It is a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information or patterns.

Data mining techniques are categorized in three ways: Discovery, Predictive modeling and Deviation and Link analysis. It discovers the usual knowledge or patterns in data, without a predefined idea or hypothesis about what the pattern may be, i.e. without any prior knowledge of fraud. It explains various affinities, association, trends and variations in the form of conditional logic.

(VIII) Laboratory Analysis of Physical and Electronic Evidences:

Computer Forensics	Protection/Validation of Evidence
hard disk imaging	Federal Rules of Evidence
E-mail analysis	Chain of Custody
search for erased files	Altered & Fictitious Documents
analyze use & possible misuse	physical examination
computer software to analyze data	fingerprint analysis
	forgeries
	ink sampling
	document dating

Question 19

Forensic audit is unlike other audits. Explain

Or

Explain how a Forensic Audit differs from an Assurance Engagement.

Answer

Difference between Forensic Audit and Assurance Engagement:

S.No.	Particulars	Other Audits	Forensic Audit
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations

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4.	Verification of stock, Estimation realisable value of assets, provisions, liability etc.	Relies on the management certificate/ Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

Question 20

ABC Ltd. is a listed company having turnover of ₹ 50 crores & plans expansion by installation of new machines at new building-having total additional project cost of ₹ 20 crore.

Rupees (In crore)	Purpose
10.0	- for Building
8.5	- for Machinery
<u>1.5</u>	- for Working Capital
<u>20 Crore</u>	

Project gets implemented in 2017-18 and one of the accountants points out to Managing Director that something wrong has happened in the purchase of building material.

On hearing this, the management is planning to appoint Forensic Auditor. Advise management that how is a forensic accounting analysis is different from an audit.

Answer

Difference between a forensic accounting analysis and an audit: The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors' reliance on examining the audit trail versus examining the events' and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

A forensic accountant will often look for indications of fraud that are not subject to the scope of a financial statement audit.

There are some basic differences today between the procedures of forensic auditors and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

Sr.No.	Particulars	Other Audits	Forensic Audit
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking

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3.	Period	Normally for a particular accounting period.	No such limitations
4.	Verification of stock, Estimation realisable value of assets, provisions, liability etc.	Relies on the management certificate/ Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items(like contracts etc)	Used to vouch arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

Question 21

Enumerate the steps to be undertaken in case of forensic audit process.

Answer

Each Forensic Accounting assignment is unique. Accordingly, the actual approach adopted and the procedures performed will be specific to it. However, in general, many Forensic Accounting assignments will include the steps detailed below.

Step 1. Initialization

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand. A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

Step 2. Develop Plan

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

Step 3. Obtain Relevant Evidence

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Step 4. Perform the analysis

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The actual analysis performed will be dependent upon the nature of the assignment and may involve:

- | |
|---|
| • calculating economic damages; |
| • summarizing a large number of transactions; |
| • performing a tracing of assets; |
| • performing present value calculations utilizing appropriate discount rates; |
| • performing a regression or sensitivity analysis; |
-
- | |
|---|
| • utilizing a computerized application such as a spread sheet, data base or computer model; and |
| • utilizing charts and graphics to explain the analysis. |

Step 5. Reporting

Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future.

The forensic auditor should have active listening skills which will enable him to summarize the facts in the report. It should be kept in mind that the report should be based on the facts assimilated during the process and not on the opinion of the person writing the report.

Step 6. Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

Question 22

You have been appointed as a forensic accountant in M/s Secure Ltd. to carry out various analysis as a part of your assignment to arrive at a particular result. Specify the various analysis which might have to be carried out by you to arrive at your result.

Answer

Perform the Analysis: The actual analysis performed will be dependent upon the nature of the assignment and may involve:

- (i) calculating **economic damages**;
- (ii) **summarizing** a large number of **transactions**;

- (iii) performing a **tracing of assets**;
- (iv) performing **present value calculations** utilizing appropriate discount rates;
- (v) performing a regression or **sensitivity analysis**;
- (vi) utilizing a **computerized application** such as a spread sheet, data base or computer model; and
- (vii) utilizing **charts and graphics** to explain the analysis.

Question 23

What are the areas where the services of forensic accountants/ auditors are generally required?

Answer

Areas where the services of forensic accountants/ auditors are generally required:

- **Criminal Investigation:** Matters relating to financial implications the services of the forensic accountants are availed of. The report of the accountants is considered in preparing and presentation as evidence.
- **Professional Negligence Cases:** Professional negligence cases are taken up by the forensic accountants. Non- conformation to Generally Accepted Accounting Standards (GAAS) or non-compliance to auditing practices or ethical codes of any profession, Forensic Auditors are needed to measure the loss due to such professional negligence or shortage in services.
- **Arbitration service:** Forensic accountants render arbitration and mediation services for the business community. Their expertise in data collection and evidence presentation makes them sought after in this specialized practice area.
- **Fraud Investigation and Risk/Control Reviews:** Forensic accountants render such services both when called upon to investigate specific cases as well for a review of or for implementation of Internal Controls. Another area of significance is Risk Assessment and Risk Mitigation.
- **Settlement of insurance claims:** Insurance companies engage forensic accountants to have an accurate assessment of claims to be settled. In case of policyholders seek the help of a forensic accountant when they need to challenge the claim settlement as worked out by the insurance companies. A forensic accountant handles the claims relating to consequential loss policy, property loss due to various risks, fidelity insurance and other types of insurance claims.
- **Dispute settlement:** Business firms engage forensic accountants to handle contract disputes, construction claims, product liability claims, infringement of patent and trademarks cases, liability arising from breach of contracts and so on.

Question 24

What do you understand by the word “Forensic” and why the need for forensic audit arises?

Answer

Forensic: The word forensic comes from the **Latin word forensis, meaning "of or before the forum."** It is -

- Relating to, used in, or appropriate for **courts of law or for public discussion** or argumentation.
- Relating to the **use of science or technology in the investigation** and establishment of facts or evidence in a court of law.

Need for forensic audit:

- **Fraud Detection:** Investigating and analyzing financial evidence, detecting financial frauds and tracing misappropriated funds
- **Computer Forensics:** Developing computerized applications to assist in the recovery, analysis and presentation of financial evidence;
- **Fraud Prevention:** Either reviewing internal controls to verify their adequacy or providing consultation in the development and implementation of an internal control framework aligned to an organization's risk profile
- **Providing Expert Testimony:** Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

Chapter 17

Peer Review & Quality Review

Unit I – Peer Review

Question 1

Anand, a practicing Chartered Accountant is appointed to conduct the peer review of another practicing unit. What areas Anand should review in the assessment of independence of the practicing unit?

Answer

Review in the Assessment of Independence of the Practicing Unit – The reviewer should carry out the **compliance review of the five general controls**, i.e., independence, maintenance of professional skills and standards, outside consultation, staff supervision and development and office administration and evaluate the degree of reliance to be placed upon them. The degree of reliance will, ultimately, affect the attestation service engagements to be reviewed.

Independence is the main quality expected of an auditor. That is the very basis for the existence of the profession of auditing. Independence is a condition of mind as well a personal character of a person. It is difficult to define but very easy to perceive. Guidance Note on Independence of Auditors clarifies that **independence is of two types, viz. independence of mind and independence of appearance**. The Guidance Note further states that there are certain threats to independence which are classified as self interest threats, self review threats, advocacy threats, familiarity threats and intimidation threats.

The responsibility of the Peer Reviewer, therefore, is to ascertain the existence of independence and the absence of threats to independence.

The reviewer should, therefore, **check the following aspects in respect of assessment of independence of the practicing unit:**

- (i) Does the practice unit have a **policy to ensure independence, objectivity and integrity**, on the part of partners and staff? Who is responsible for this policy?
- (ii) Does the practice unit **communicate these policies** and the expected standards of professional behaviour to all staff?
- (iii) Does the practice unit **monitor compliance with policies and procedures** relating to independence?
- (iv) Does the practice unit **periodically review the practice unit's association with clients** to ensure objectivity and independence?
- (v) How does the practice unit **deal with the threats to independence**?

Question 2

What are the areas excluded from the scope of peer reviewer?

Answer

Areas excluded from the scope of peer reviewer:



- (i) **Management Consultancy** Engagements;
- (ii) **Representation before various Authorities;**
- (iii) Engagements to prepare **tax returns** or advising clients in taxation matters;
- (iv) Engagements for the **compilation of financial statements;**
- (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
- (vi) **Testifying as an expert witness;**
- (vii) Providing **expert opinion on points of principle, such as Accounting Standards** or the applicability of certain laws, on the basis of facts provided by the client; and
- (viii) Engagement for **Due diligence.**

Question 3

Explain technical, ethical and professional standards as per statement on peer review.

Answer

Technical, Ethical and Professional Standards as per Statement on Peer Review: As per the Statement, Technical, Professional and Ethical Standards means-

- (i) **Accounting Standards issued by ICAI** that are applicable for entities other than companies under the Companies Act, 2013;
- (ii) **Accounting Standards prescribed under section 133 of the Companies Act 2013** by the Central Government based on the recommendation of ICAI and in consultation with the National Financial Reporting Authority (NFRA) and notified as Accounting Standards Rules 2006, as amended from time to time;
- (iii) **Indian Accounting Standards prescribed under section 133 of the Companies Act 2013** by the Central Government based on the recommendation of ICAI and in consultation with NFRA and notified as Companies (Indian Accounting Standards) Rules, 2015, as amended from time to time;
- (iv) Standards issued by the Institute of Chartered Accountants of India including-
 - (a) **Engagement standards**
 - (b) **Statements**
 - (c) **Guidance notes**
 - (d) **Standards on Internal Audit**
 - (e) **Statements on Quality Control**
 - (f) **Notifications** / Directions / Announcements / Guidelines / Pronouncements/ Professional standards issued from time to time by the Council or any of its committees.
- (v) **Framework for the preparation and presentation of financial statements**, Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services and Framework for Assurance engagements;
- (vi) **Provisions of the relevant statutes** and/or rules or regulations which are applicable in

the context of the specific engagements being reviewed including instructions, guidelines, notifications, directions issued by regulatory bodies as covered in the scope of assurance engagements.

Question 4

Explain Stepwise approach adopted by the Peer reviewer.

Answer

Stepwise Approach of the Peer Reviewer: The stepwise approach which may be adopted by the reviewer is discussed below-

- (i) The reviewer should **gain an understanding of the engagement letter** since an assurance engagement or for that matter any other kind of engagement should begin with an engagement letter. This understanding would help him in planning the review of documentation.
- (ii) The **number of assurance engagements to be selected requires the exercise of judgement** by the reviewer based on the evaluation of replies given in the questionnaire and the size of the practice unit.
- (iii) The practice unit may have **policies and procedures for accepting a particular engagement**. The reviewer should, wherever possible, examine that the policies and procedures for acceptance of audit have been complied with and necessary documentation with regard to the same exists.
- (iv) The reviewer may **follow a combination of compliance procedures and substantive procedures** throughout the peer review process.
- (v) Finally, the reviewer **while evaluating records may consider** the following:
 - determine that **any significant issues, matters, problems** that arose during the course of the engagement have been appropriately considered, resolved and documented;
 - determine that **adequate audit evidence** or other relevant evidence in relation to the engagement is **obtained** to support the reasonableness of the conclusions drawn; and
 - determine that **significant decisions** relating to the engagement, **use of professional judgement**, resolution of significant matters have been properly documented.

Question 5

Write short note on scope of peer review.

Answer

Scope of Peer Review: The Statement on Peer Review lays down the scope of review to be conducted as under:

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

1. Once a Practice Unit is selected for Review, its **assurance engagement records** pertaining to the Peer Review Period shall be **subjected to Review**.
2. The **Review shall cover:**

- (i) **Compliance with Technical, Professional and Ethical Standards:**
- (ii) **Quality of reporting.**
- (iii) **Systems and procedures** for carrying out assurance services.
- (iv) **Training programmes** for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
- (v) **Compliance with directions and/or guidelines issued by the Council to the Members, including Fees** to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
- (vi) Compliance with directions and/or guidelines issued by the Council in **relation to article assistants** and/or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.

Question 6

The elements of skill, experience and independence of reviewers are ensured before initiating them in Peer Review process. In the above light, state few eligibility criteria fixed for a person to be empanelled and also for being appointed as a Peer Reviewer.

Answer

Eligibility to be a Reviewer:

1. A Peer Reviewer shall: -
 - (a) Shall be a **member in practice with at least 10 years of experience for Level I entities and 7 years of experience for Level II entities.**
 - (b) In case a member has moved from industry to practice and is currently in practice he should have **at least 15 years of experience in industry** and at least 5 years' experience in practice for Level I entities and an experience of at least 10 years in industry and at least 3 years' experience in practice, for Level II entities.
 - (c) Should have **undergone the requisite training** and cleared the requisite test for Peer Review as prescribed by the Board.
 - (d) Should have **conducted audit of Level I Entities for at least 7 years** or got his entity audited for at least 7 years which should be a Level I entity to be eligible for conducting Peer Review of Level I Entities.
2. A member on being appointed as a Reviewer shall be required to -
 - (a) **furnish a declaration** as prescribed by the Board, at the time of acceptance of Peer Review appointment.
 - (b) **sign a Declaration of Confidentiality** as per Annexure A to this Statement .
3. A member **shall not be eligible** for being appointed as a Reviewer, if -
 - (i) any **disciplinary action** / proceeding is pending against him
 - (ii) he has been **found guilty of professional or other misconduct** by the Council or the Board of Discipline or the Disciplinary Committee at any time
 - (iii) he has been **convicted by a competent court** whether within or outside India, of an offence involving moral turpitude and punishable with imprisonment
 - (iv) he or his partners or personnel has any obligation or **conflict of interest** in the

Practice Unit.

4. A Reviewer **shall not accept any professional assignment from the Practice Unit for a period two years from the date of appointment.** Further, he should not have accepted any professional assignment from the Practice Unit for a period of two years before the date of appointment as reviewer of that Practice Unit.

Question 7

What are the objectives of Peer Review?

Answer

Objectives of Peer Review: The main objective of Peer Review is to ensure that in carrying out the assurance service assignments, the members of the Institute-

- (1) **comply with Technical, Professional and Ethical Standards** as applicable including other regulatory requirements thereto and
- (2) have in place **proper systems including documentation** thereof, to amply demonstrate the quality of the assurance services.

Thus, the **primary objective of peer review is not to find out deficiencies but to improve the quality of services** rendered by members of the profession. The Statement of Peer Review also makes it clear that the peer review, "**does not seek to redefine the scope and authority** of the Technical Standards specified by the Council but seeks to enforce them within the parameters prescribed by the Technical Standards".

The peer review is **directed towards maintenance as well as enhancement of quality of assurance services** and to provide guidance to members to improve their performance and adherence to various statutory and other regulatory requirements. Such an objective of the peer review process makes it amply clear that the **reviewer is not going to sit on the judgment** of the practice unit while rendering assurance services but to evaluate the procedure followed by the practice unit in rendering such a service. Accordingly, where a practice unit is not following technical standards, the **reviewers are expected to recommend measures to improve the procedures.** To elaborate further, the key objective of peer review exercise is not to identify isolated cases of engagement failure, but to identify weaknesses that are pervasive and chronic in nature. The conclusion, therefore, is that the **peer review seeks to identify and address patterns of non-compliance with quality control standards.**

Question 8

What are the inherent limitations of Peer Review?

Answer

Inherent Limitations of Peer Review: The reviewer **conducts the review in accordance with the Statement on Peer Review.** The review would **not necessarily disclose all weaknesses** in compliance of technical standards and maintenance of quality of assurance services since it would be **based on selective tests.** As there are inherent limitations in the effectiveness of any system of quality control which happens to be subject-matter of review, **departure from the system may occur and may not be detected.**

Question 9

Write a short note on Selection of sample by the reviewer in case of peer review

Answer

Selection of Sample by the Reviewer in case of Peer Review:

- (i) The Reviewer shall **within 15 days of receiving the information from the Practice Unit select a sample of the assurance services** that he would like to Review and intimate the same to the Practice Unit.
- (ii) The Reviewer may also seek **further/additional clarification from the Practice Unit** on the information furnished/not furnished.
- (iii) The Reviewer shall **plan for an on-site Review visit or initial meeting** in consultation with the Practice Unit. The Reviewer shall give the Practice Unit at least fifteen days' time to keep ready the necessary records of the selected assurance services.
- (iv) The **Reviewer and Practice Unit shall mutually cooperate and ensure that the entire Review process is completed within 90 days** from the date of notifying the Practice Unit about its selection for Review.

Question 10

ABC & Co LLP is a large firm of Chartered Accountants based out of Chennai. ABC & Co. LLP is subject to peer review which was last conducted 3 years back. For the peer review of the financial year ended 31 March 2021, the firm got an intimation on 31 May 2021. The process of peer review got started and was completed on 29 September 2021. In view of peer reviewer, the systems and procedures of ABC & Co. LLP are deficient/non-compliant. The peer reviewer did not share any of his observations with ABC & Co LLP as draft and final report was submitted to the Board. Comment.

Answer

Peer Review Report of Reviewer: After completing the on-site Review, the Peer Reviewer, before making his Report to the Board, **shall communicate his findings in the Preliminary Report to the Practice Unit** if in his opinion, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification.

The **Practice Unit shall within 15 days** after the date of receipt of the findings, **make any submissions or representations**, in writing to the Reviewer. (i.e. Response to the Preliminary Report).

At the end of an on-site Review **if the Reviewer is satisfied with the reply received from the Practice Unit, he shall submit a Peer Review Report to the Board along with his initial findings**, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

In case the Reviewer is of the opinion that the **response by the Practice Unit is not satisfactory, the Reviewer shall accordingly submit a modified Report to the Board** incorporating his reasons for the same. The Reviewer shall also submit initial findings (**i.e. Preliminary Report**), response by the Practice Unit (**Response to Preliminary Report**) and

the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

In case of a modified report, The Board shall order for a **“Follow On” Review after a period of one year from the date of issue of report** as mentioned above. If the Board so decides, the period of one year may be reduced but shall not be less than six months from the date of issue of the report.

In the instant case, in view of peer reviewer systems and procedures in ABC & Co. LLP are deficient, therefore, peer reviewer should not submit the report directly to the Board. Thus, contention of ABC & Co. LLP is correct.

Question 11

Every Practice Unit including its branches, based on their category as determined below will be subject to Peer Review in accordance with this Statement. Determine the Level I Practice Units.

Answer

A Practice Unit which has undertaken any of the under-mentioned assurance services in the period under review shall be treated a Level I entity:

- (i) **Central Statutory Audit of Public Sector Banks**, Private Sector Banks, Foreign Banks, Cooperative Banks and Public Financial Institutions;
- (ii) Central Statutory Audit of Central or State **Public Sector Undertakings and Central Cooperative Societies** based on criteria such as turnover or paid up capital etc. as may be decided by the Board;
- (iii) Central Statutory Audit of **Insurance Companies**;
- (iv) Statutory Audit of **asset management companies or mutual funds**;
- (v) Statutory Audit of **enterprises whose equity or debt securities are listed in India or abroad**;
- (vi) Statutory audit of **any body corporate including trusts** which are covered under public interest entities.
- (vii) Statutory Audit of Entities which have **raised funds** from public or banks or financial institutions of **over Rupees Fifty Crores** during the period under Review;
- (viii) Statutory Audit of Entities which have **raised donations** and/or contributions **over Rupees Fifty Crores** during the period under Review;
- (ix) Statutory Audit of entities **having net worth of more than two Hundred and Fifty Crores rupees** at any time during the period under Review.
- (x) Statutory Audit of entities which have been **funded by Central and/or State Government(s) schemes of over Rupees Fifty Cores** during the period under Review.
- (xi) Statutory Audit of **Non-Banking Financial Companies** as may be defined by the Board.
- (xii) Central Statutory Audit of **Regional Rural Banks**.
- (xiii) Statutory Audit of **parent, subsidiary, associate, and joint venture of the above entities**.

Question 12

Every Practice Unit including its branches, based on their category as determined below will be

subject to Peer Review in accordance with this Statement. Determine the Level II Practice Units.

Answer

A Practice Unit which has undertaken any of the under-mentioned assurance services in the period under review shall be treated as Level II entity:

- (i) **Statutory / Internal / Concurrent / Systems / Tax audit and / or Departmental Review of Branches / Offices of -**
 - (a) **Public Sector undertaking**
 - (b) **Public Sector or Private Sector and / or Foreign Banks**
 - (c) **Insurance Companies**
 - (d) **Co-operative Banks**
 - (e) **Regional Rural Banks**
- (ii) **Statutory Audit of Non-Banking Financial Companies** as may be defined by the Board.
- (iii) **Statutory Audit of entities having Net Worth of over Five Crores rupees or an annual turnover of more than Fifty Crores rupees** during the period under Review.
- (iv) **UDIN's generated by the Practice Units more than the specified number** determined by the Board from time to time.
- (v) **Statutory Audit of entities which have raised funds** from public or banks or financial institutions of **more than Twenty Five Crores rupees but less than Fifty Crores rupees** during the period under review.
- (vi) **Any other Practice Unit providing assurance or other services** not covered under (i) (ii), (iii), (iv) and (v) hereinabove.

Question 13

Write short note on difference between Peer Review and Quality Review.

Answer

Peer review is a review of the systems and procedures of an audit firm. Although sample audit files are inspected by the peer reviewer, it is **done for the purpose of testing the effectiveness of the systems and procedures.** The intention is to **not to find faults but to help the firm develop effective systems.** It is a **kind of mentoring process.** Peer review is a **part of the activities of ICAI** aimed at improving the quality of service.

In contrast, a **quality review is supposed to act as a deterrent.** Quality Review Board (**QRB**) is **constituted by the Central Government and is independent of ICAI.** As per Section 28A of the Chartered Accountant's Act, the Central Government has the authority to constitute a Quality Review Board. QRB carries out supervisory and disciplinary functions. A quality review normally pertains to one particular audit conducted by an audit firm. The **main objective of quality review is to find errors or inadequacies, if any, committed by the auditor while conducting the audit.** Serious errors detected in quality review lead to disciplinary action against the member.

Question 14

CA S has been appointed as peer reviewer of Shivam & Co. LLP. Shivam & Co. LLP submitted a list of its assurance and due diligence services for the peer review. CA S is in the process of deciding as to how many assurance services should be reviewed. Guide CA S in deciding the number of assurance services engagement to be reviewed.

Answer

The number of assurance service engagements to be reviewed shall depend upon:

- ◆ The **Standard of quality controls** generally prevailing;
- ◆ The **size and nature of assurance service engagements** undertaken by the Practice Unit.
- ◆ The **methodology generally adopted** by the Practice Unit in providing assurance services.
- ◆ The **number of partners/members involved** in assurance service engagements in the Practice Unit;
- ◆ The **number of locations/branch offices** of the practice Unit;

Unit II – Quality Review**Question 15**

Briefly discuss the Various Stages involved in the Conduct of the Quality Review Assignments

Answer

Various Stages involved in the Conduct of the Quality Review Assignments are:

- **Selection of Audit Firm and Technical Reviewer** to conduct Quality Review and sending Offer Letter of Engagement to the Technical Reviewer.
- Technical Reviewer to **convey his acceptance of Letter of Engagement** by sending necessary declarations for meeting eligibility conditions and furnishing statement of confidentiality by the Technical Reviewer and his assistant/s, if any.
- **Intimation to the Audit Firm** about the proposed Quality Review and acceptance of the assignment by the Technical Reviewer. Also marking a copy of the intimation to the Technical Reviewer.
- Technical Reviewer to send the **specified Quality Review Program General Questionnaire** to the Audit firm for filling-up and call for additional information from the Audit Firm, if required.
- Technical Reviewer to **carry out the Quality Review by visiting the office** of the Audit Firm by fixing the date as per mutual consent.
- Technical Reviewer to **send the preliminary report to Audit firm.**
- **Audit firm to submit representation on preliminary report** to the Technical Reviewer.
- **Technical Reviewer to submit final report** alongwith a copy of Annual report of the company/entity for the year, to the Board in the specified format, on their (individual) letterhead, duly signed and dated **within 45 days** from the date of acceptance of the assignment.
- Technical Reviewer should **also send a copy of their final report to the Statutory Auditor/Audit firm**, requesting the firm to send their submissions thereon to the Board within 7 days of receipt of the final report with a copy to Technical Reviewer. Upon receipt

of their final submission, Technical Reviewer shall submit within next 7 days a summary of their findings, reply of the audit firm thereon alongwith their final comments in the specified format.

- **Quality Review Group** to consider the report of the Technical Reviewer and responses of the Audit firm and **make recommendations to Quality Review Board.**
- **Quality Review Board** to consider the report of the Quality Review Group and **decide the final course of action.**

Question 16

What are the objectives of the Quality Review?

Answer

Objectives of Quality Review: Quality review is directed towards **evaluation of audit quality and adherence to various statutory and other regulatory requirements.** They are designed to identify and address weaknesses and deficiencies related to how the audits were performed by the audit firms. To achieve that goal, quality reviews included reviews of certain aspects of selected statutory audits performed by the firm and reviews of other matters related to the firm's quality control system.

In the course of reviewing aspects of selected audits, a review may identify ways in which a particular audit is deficient, including failures by the firm to identify, or to address appropriately, aspects in which an entity's financial statements do not present fairly the financial position or the results of operations in conformity with the applicable Generally Accepted Accounting Principles (GAAP) and other technical standards. **It is not the purpose of a review, however, to review all of a firm's audits or to identify every aspect in which a reviewed audit is deficient.** Accordingly, a review should not be understood to provide any assurance that the firm's audits, or its clients' financial statements or reporting thereon, are free of any deficiencies.

The scope & objective of the quality review includes:

- (a) Examining whether the Statutory Auditor has **ensured compliance with the applicable technical standards** in India and other applicable professional and ethical standards and **other relevant guidance.**
- (b) Examining whether the Statutory Auditor has ensured compliance with **the relevant laws and regulations as required under applicable auditing standard.**
- (c) Examining whether the Audit firm under review (AFUR) has **implemented a system of quality control with reference to the applicable quality control standards.**
- (d) **Examining whether there is no material misstatement of assets and liabilities** as at the reporting date in respect to the selected entity.

Question 17

Write short note on scope of the Quality review.

Answer

The scope of the quality review includes:

- (a) Examining whether the Statutory Auditor has **ensured compliance with the applicable technical standards** in India and other applicable professional and ethical standards and **other relevant guidance**.
- (b) Examining whether the Statutory Auditor has ensured compliance with **the relevant laws and regulations as required under applicable auditing standard**.
- (c) Examining whether the Audit firm under review (AFUR) has **implemented a system of quality control with reference to the applicable quality control standards**.
- (d) **Examining whether there is no material misstatement of assets and liabilities** as at the reporting date in respect to the selected entity.

Question 18

What are the reporting responsibilities of the technical reviewer while carrying out a Quality review assignment?

Answer

The Technical Reviewers expresses an opinion on **whether the system of quality control** for the attestation services of the firm under review has been designed so as to carry out professional attestation services assignments in a manner that **ensures compliance with the applicable Technical standards** and maintenance of the quality of attestation service work they perform. The Technical Reviewer's review would **not necessarily disclose all weaknesses** in the quality of attestation work or all instances of lack of compliance with applicable Technical Standards. As there are **inherent limitations** in the effectiveness of any system of quality control, **departure from the system may occur** and not be detected. Also, **projection** of any evaluation of system of quality control to future periods is subject to the **risk** that the system of quality controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate. In the process, the Technical Reviewers also identified what they considered to be deficiencies and any defects in, or criticisms of the firm's quality control system.

Question 19

Give examples of areas on which the reviewer may qualify the report?

Answer

A reviewer may qualify the report due to one or more of the following:

- non-compliance with **technical standards** and other relevant guidance;
- non-compliance with **relevant laws and regulations** as required under applicable auditing standard;
- quality control system **design deficiency**; or
- non-compliance with **quality control policies and procedures**.

Question 20

What are the consequences if the Quality review board notices major non-compliances with the requirements of the Standards on quality control or standards on auditing or accounting standards?

Answer

The actions that the Board may take, based upon consideration of recommendations of the QRG, include one or more of the following:-

- **Make recommendations to the Council of ICAI u/s 28B(a) of Chartered Accountants Act, 1949 for referring the case to the Director (Discipline) of the Institute for consideration and necessary action under the Chartered Accountants Act, 1949.**
- **Issue advisory and guidance to the AFUR u/s 28B(c) of Chartered Accountants Act, 1949 for improvement in the quality of services and adherence to various statutory and other regulatory requirements. A copy of such advisory may also be sent to the ICAI for information.**
- **Inform the details of the non-compliance to the regulatory bodies relevant to the entities as may be decided by the Board.**
- Intimate the AFUR as to the **findings of the Report as well as action initiated** as above.
- In case of review arising out of a reference received from a regulatory body, inform the results of review and the details of action taken to the concerned regulatory body.
- **Consider the matter complete** and inform the AFUR accordingly.

Question 21

What are the important areas for evaluation while conducting quality reviews in terms of SQC -1 Standard on Quality Control?

Answer

Important areas for evaluation while conducting quality reviews in terms of SQC -1 Standard on Quality Control are:

- Whether the audit firm **establishes and implements policies and procedure** on all the elements of system of quality control
- Whether the engagement quality control **reviewer review at an appropriate time for the planning of an audit**, significant audit judgement, and expressions of an audit opinion.
- Whether the audit firm **assigns as the person responsible for the monitoring of the system of quality control a person with appropriate experience for the role**, vest the assigned person with sufficient and appropriate authority.
- Whether the audit firm **obtain, at least annually, a confirmation letter** concerning compliance with policies and procedure **for the maintenance of independence** from all persons required to maintain independence.
- Whether the audit firm **perform the independence confirmation procedure** set forth in its internal rules before acceptance and continuance of an audit engagement, and when issuing the auditor's report appropriately confirms that there was no change in the status of independence.
- Whether the audit firm **develop and provides education/training program**

Chapter 18

Professional Ethics

Comment with reference to the Chartered Accountants Act, 1949 and Schedules thereto:

Basics

Question 1

A professional accountant in public practice is always subject to various threats in compliance with fundamental principles of his profession and you, as a professional accountant, are worried about engagement specific threat in your audit assignment of M/s Soft Ltd. and want to implement some measures to eliminate and reduce the same. Enumerate some engagement specific safeguards which you may introduce in your work environment to ward off such threats.

Answer

Engagement-specific safeguards in the work environment may include:

- (i) Involving an additional professional accountant to review the work done or otherwise advise as necessary.
- (ii) Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- (iii) Discussing ethical issues with those charged with governance of the client.
- (iv) Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.
- (v) Involving another firm to perform or re-perform part of the engagement.
- (vi) Rotating senior assurance team personnel.

Question 2

A Chartered Accountant in practice has been suspended from practice for a period of 6 months and he had surrendered his Certificate of Practice for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a Chartered Accountant.

Answer

Undertaking Tax Representation Work: A chartered accountant not holding certificate of practice cannot take up any other work because it would amount to violation of the relevant provisions of the Chartered Accountants Act, 1949.

In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practices as a member of the Institute. This is because once a person becomes a member of the Institute; he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations.

If he appears before the income tax authorities, he is only doing so in his capacity as a chartered accountant and a member of the Institute. Having bound himself by the said Act and its

Regulations made there under, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity.

Conclusion: Thus, in the instant case, a chartered accountant would not be allowed to represent before the income tax authorities for the period he remains suspended. Accordingly, in the present case he is guilty of professional misconduct.

Question 3

Mr. Dice, a practising Chartered Accountant was ordered to surrender his Certificate of Practice and he was suspended for one year on certain professional misconduct against him. During the period of suspension, Mr. Dice, designating himself as GST Consultant, did the work of filing GST returns and made appearance as a consultant before various related authorities. He contended that there is nothing wrong in it as he, like any other GST consultant, could take such work and his engagement as such in no way violates the order of suspension inflicted on him.

Answer

Filing of GST Returns and Appearance as GST Consultant: A chartered accountant not holding certificate of practice cannot take up any other work in the capacity of Chartered Accountant in practice because it would amount to violation of the relevant provisions of the Chartered Accountants Act, 1949.

In case a member is suspended and is not holding Certificate of Practice, he cannot in any other capacity take up any practice separable from his capacity to practices as a member of the Institute. This is because once a member becomes a member of the Institute, he is bound by the provisions of the Chartered Accountants Act, 1949 and its Regulations.

In case he files GST returns and appears as a consultant before various related authorities in his capacity as a chartered accountant and a member of the Institute, having bound himself by the said Act and its Regulations made thereunder, he cannot then set the Regulations at naught by contending that even though he continues to be a member and has been punished by suspension, he would be entitled to practice in some other capacity. But if he is doing so in any other capacity such as GST Consultant wherein his capacity is not chartered accountant in practice, he will not be held guilty for misconduct.

In the instant case, Mr. Dice was a practicing chartered accountant and he was ordered to surrender his certificate of practice and was suspended for one year. Mr. Dice is doing the work of filing GST returns and has appeared as a consultant before various related authorities as GST Consultant which is not in capacity of a practicing chartered accountant rather in capacity of authorized representative. Any person who has been authorized to act as a GST Practitioner on behalf of the concerned registered person can become authorized representative. Thus, Mr. Dice would not be allowed to represent as a Chartered Accountant before various related authorities for the period he remains suspended. Accordingly, in the present case he is guilty of professional misconduct.

Question 4

-Mr. A, a practicing Chartered Accountant agreed to select and recruit personnel, conduct training programmes for and on behalf of a client.

Answer

Providing Management Consultancy and Other Services: Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed “to be in practice” when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice. Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of “Management Consultancy and other Services”.

The definition of the expression “Management Consultancy and other Services” includes Personnel recruitment and selection. Personnel Recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of workloads.

Conclusion: Therefore, Mr. A is not guilty of professional misconduct.

Question 5

Mr. Sam, a Chartered Accountant in practice, provides guidance on post -issue activities to his clients e.g. follow up steps which include listing of instruments dispatch of certificates and refunds etc. with the various agencies connected with the work. During the year 2019-20, looking to the growing needs of his clients to invest in the stock markets, he also started advising them on Portfolio Management Services whereby he managed portfolios of some of his clients.

Answer

Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting a Chartered Accountant in practice to render entire range of “Management Consultancy and other Services”. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, underwriters etc., advice regarding post issue activities, like, follow up steps for listing of instruments, dispatch of certificates, refunds etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services.

In the given case, Mr. Sam has started advising his clients on portfolio management along with other management consultancy services related to an issue.

Therefore, Mr. Sam would be guilty of misconduct under the Chartered Accountants Act, 1949 as a chartered accountant in practice is not permitted to manage portfolios of his clients.

Question 6

P, a Chartered Accountant in practice provides management consultancy and other services to his

clients. During 2020, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients.

Answer

Advising on Portfolio Management Services: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting “Management Consultancy and other Services” by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

Question 7

CA Natraj, in practice, accepted an assignment as advisor and consultant to the public issue of shares by his client M/s Super Ltd. Besides helping the company as an advisor, he also underwrote the public issue of the company to the extent of 25% at a commission of 1%. Remaining shares were underwritten by banks and other financial institutions at the same rate of commission. He contends that above assignments are part of management consultancy work permitted by the council of the Institute. Do you agree with the view of CA Natraj? Decide in the light of applicable code of conduct.

Answer

Assignment as Advisor and Consultant: The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting “Management Consultancy and other Services” by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services.

In the instant case, CA Natraj accepted an assignment as advisor and consultant to the public issue of shares by his client M/s Super Ltd. In addition, he also underwrite the public issue of the company to the extent of 25% at a commission of 1%. Contention of CA. Natraj that advisor, consultant and underwriting work is part of management consultancy work and permitted by the council is not correct as Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management services.

Conclusion: In view of this, CA. Natraj would be guilty of misconduct under the Chartered Accountants Act, 1949.

Question 8

Write a short note on - Maintenance of branch offices by Chartered Accountants in practice.

Answer

Maintenance of Branch Offices by Chartered Accountants in Practice: Section 27 of the Chartered Accountants Act, 1949 requires that if a chartered accountant in practice or a firm of chartered accountants has more than one office in India, i.e., a branch, each of such offices should be in the separate charge of a member of the Institute. Failure on the part of a member or a firm, to have a member in charge of its branch office and a separate member in case of the branches, if more than one, would constitute professional misconduct. However, exemption from the above has been given to members practising in the hilly areas subject to the certain conditions.

It is necessary to mention that the Chartered Accountant in charge of the branch of another firm should be associated with him or with the firm either as a partner or as a paid assistant. If he is a paid assistant, he must be in whole time employment with him. The above rule applies in case additional office is situated at a place beyond 50 Kms. from the municipal limits in which the office is situated.

The exemption may be granted under proviso to section 27(1) of the Chartered Accountants Act, 1949 to a member or a firm of Chartered Accountants in practice to have a second office without such second office being under the separate charge of a member of the Institute, provided (a) the second office is located in the same premises, in which the first office is located or (b) the second office is located in the same city, in which the first office is located or (c) the second office is located within a distance of 50 km. from the municipal limits of a city, in which the first office is located. A member having two offices of the type referred to above shall have to declare, which of the two offices is his main office which would constitute his professional address.

Question 9

Mr. G, a Chartered Accountant in practice as a sole proprietor has an office in Mumbai near Church Gate. Due to increase in professional work, he opens another office in a suburb of Mumbai which is approximately 80 kilometers away from the municipal limits of the city. For running the new office, he employs three retired Income-tax Officers.

Answer

In terms of section 27 of the Chartered Accountants Act, 1949, if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however an exemption for the above if the second office is located in the same premises, in which the first office is located; or the second office is located in the same city, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of a city, in which the first office is located. Since the second office is situated beyond 50 kms of municipal limits of Mumbai city, he would be liable for committing a professional misconduct.

Question 10

Mr. K Chartered Accountant in practice as a sole proprietor at Chennai has an office in the

suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office, which is within the city and at a distance of 30 kms. from his office in the suburb. For running the new office, he has employed a retired Income Tax Commissioner who is not a Chartered Accountant.

Answer

Maintenance of Branch Office in the Same City: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 Kilo metres from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch within the city near the income tax office. He also employed a retired income tax commissioner to run the new office and the second office is situated within a distance of 30 kilometers from his office in the suburb.

In view of above provisions, there will be no misconduct if Mr. K will be in-charge of both the offices. However, he is bound to declare which of the two offices is the main office.

Question 11

M & Co., a sole proprietary Chartered Accountant firm in practice with an office in a busy belt of a city, had great difficulty in regularly attending to the consultancy needs of his clients who are mostly located in an industrial cluster in a nearby outskirts which is situated at a distance of 26 kms from the office of the firm. To mitigate the difficulty and to have ease of business, a facilitation centre was opened in the industrial cluster. The proprietor managed, both the office and the facilitation centre, by himself. No intimation was made to the Institute of Chartered Accountants of India. Examine whether there, is any professional misconduct in this respect.

Answer

Maintenance of Branch Office in the Same City: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 Kilometres from the municipal limits of a city, in which the first office is located. Further a member having two offices of the type referred to above, shall have to declare which of the two offices is his main office, which would constitute his professional address.

In the given case, M & Co., a sole proprietary Chartered Accountant firm in practice with an office in a busy belt of a city and had great difficulty in regularly attending to the consultancy needs of his clients. Therefore, a facilitation centre was opened in the industrial cluster and the proprietor is managing both the office and facilitation centre. Though distance between his office and facilitation centre i.e. sort of second office is within prescribed range i.e. 50 kilometres but M& Co., will be liable for misconduct as prescribed intimation about facilitation centre and main

office should be sent to the Institute of Chartered Accountants of India.

Question 12

Mr. X & Mr. Y, partners of a Chartered Accountant Firm, one in-charge of Head Office and another in-charge of Branch at a distance of 80 kms from the municipal limits, puts up a name-board of the firm in both premises and also in their respective residences.

Answer

Putting Name Board of the Firm at Residence: The council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm.

In the given case, partners of XY & Co., put up a name board of the firm in both offices and also in their respective residences.

Thus, the chartered accountants are guilty of misconduct. Distance given in the question is not relevant for deciding.

Question 13

Write a short note on Importance of KYC requirements for a Chartered Accountant's practice.

Answer

Importance of KYC Requirements for a Chartered Accountant's Practice: The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI recommended such norms to be observed by the members of the profession who are in practice. These Know Your Client (KYC) Norms are also important in order to ensure a healthy growth of the profession and an equitable flow of professional work among the members.

The self-regulatory measures are recommendatory. However, considering the spirit underlying these measures, it is expected that every Chartered Accountant carrying out attest function is encouraged to follow them and implementation of these measures would go a long way in ensuring equitable flow of work among the members and would also further enhance the prestige of the profession in the society.

Question 14

Mr. F, a Chartered Accountant, gave advisory services to PQR Pvt. Ltd. Further, he gave them GST consultancy and helped in ERP set up. Later, the company turned out to be a part of a group of companies involved in money laundering. Mr. F was asked to provide details of the companies. Mr. F refused on the grounds that he gave only consultancy services to the company and wasn't supposed to keep any information about the company. Is Mr. F right as per the guidelines issued by the ICAI?

Answer

The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI issued such norms to be observed by the members of the profession who are in practice.

In the given situation, CA. F, gave GST consultancy and helped in ERP set up along with advisory services to PQR Pvt. Ltd. Mr. F was asked to provide details of the companies as the company, turned out to be a part of a group of companies, involved in money laundering. Contention of Mr. F that he gave only consultancy services to the company and wasn't supposed to keep any information about the company is not valid as Mr. F should have kept following information in compliance with KYC Norms which are mandatory in nature and shall apply in all assignments pertaining to attestation functions.

In the given case of PQR Pvt. Ltd., a Corporate Entity, Mr. F should have kept following information:

- A. General Information
 - Name and Address of the Entity Business Description
 - Name of the Parent Company in case of Subsidiary
 - Copy of last Audited Financial Statement
- B. Engagement Information
 - Type of Engagement
- C. Regulatory Information
 - Company PAN No. Company Identification No.
 - Directors' Names & Addresses Directors' Identification No.

Question 15

Write a short note on Other Misconduct.

Answer

Other Misconduct:

- (i) A member is liable to disciplinary action under Section 21 of the Chartered Accountant Act if he is found guilty of any professional or 'other misconduct'.
- (ii) Other misconduct has been defined in Part IV of First Schedule and Part III of Second Schedule in the CA (Amendment Act) 2006.
- (iii) As per Part IV of First Schedule of the CA Act, a member of the Institute whether in practice or not, shall be deemed to be guilty of other misconduct if he-
 1. Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.
 2. 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.
- (iv) As per Part III of Second Schedule to the CA Act, a member of the Institute whether in practice or not shall be deemed to be guilty of other misconduct if he Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term

exceeding six months.

This provision empowers the Council to enquire any misconduct of a member even if it does not arise of professional misconduct.

Some illustrative examples, where a member may be found guilty of “Other Misconduct”, under the aforesaid provisions rendering, himself unfit to be member are:

- (i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
- (ii) Where a chartered accountant makes a material misrepresentation.
- (iii) Where a chartered accountant uses the services of his articled or audit assistant for purposes other than professional practice.
- (iv) Conviction by a competent court of law for any offence under Section 8(v) of the Chartered Accountants Act 1949.
- (v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.
- (vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.
- (vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed-room of the chartered accountant.
- (viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.

Question 16

Mr. A, a practicing Chartered Accountant, failed to return the books of account and other documents of a client despite many reminders from the client. The client had settled his entire fees dues also.

Answer

Bringing Disrepute to the Profession: A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, 1949, 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-

- (1) is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;
- (2) 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.

A member may be found guilty of “Other Misconduct”, as per Clause (2), under the aforesaid provisions rendering, himself unfit to be member if he retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.

In the given case, Mr. A failed to return the books of accounts and other documents of his client without any reasonable cause, therefore, he would be guilty of other misconduct under the

afore said provisions.

Question 17

Mr. R, a Chartered Accountant in practice has been elected as the treasurer of a Regional Council of the Institute. The Regional Council had organized an international tour through a tour operator during the year for its members. During the audit of the Regional Council, it was found that Mr. R had received a personal benefit of ₹ 50,000 from the tour operator.

Answer

Embezzlement of Funds: Section 21 of the Chartered Accountants Act, 1949 provides that a member is liable for disciplinary action if he is guilty of any professional or “Other Misconduct.” Though the term “Other Misconduct” has not been defined in the said Act, this provision enables the Council to enquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards 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. The Council has also laid down that among other things “misappropriation by an office-bearer of a Regional Council of the Institute of a large amount and utilization thereof for his personal use” would amount to “other misconduct”. Thus, in the instant case, Mr. R would be liable for disciplinary action.

Question 18

CA Kumar who is contesting Central Council Elections of Institute, engages his Articled Assistant for his election campaigning promising him that he will come in contact with influential people which will help to enhance his career after completion of his training period.

Answer

Other Misconduct: CA Kumar has engaged his Articled Assistant for his own election campaigning for the central Council elections of ICAI.

This aspect is covered under ‘Other Misconduct’ which has been defined in Part IV of the First Schedule and Part III of the Second Schedule. These provisions empower the Council even if it does not arise out of his professional work This is considered necessary because a Chartered Accountant is expected to maintain the highest standards 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.

Thus, when a Chartered Accountant uses the services of his Articled Assistant for purposes other than professional practice, he is found guilty under ‘Other Misconduct’.

Hence, CA Kumar is guilty of ‘Other Misconduct’

First Schedule

Question 19

CA Sant, a newly qualified professional with certificate of practice, approached CA Pant, the auditor of his father's company M/s Max Ltd., to allow him to have some practical and professional knowledge and experience in his firm before he can set up his own professional practice. CA Pant allowed him to sit in his office for 6 month and allotted a small chamber with other office infrastructure facility. In the course of his association with CA Pant' s office, he used to provide tax consultancy independently to the client of the firm and also filed few IT and GST return and represented himself before various tax authorities on behalf of the firm although no documents were signed by him. During his association in CA Pant's office, he did not get any salary or share of profit or commission but only re-imbursement of usual expenses like conveyance, telephone etc. was made to him. After the end of the agreed period, he was given a lump sum amount of ₹ 3,00,000 by CA Pant for his association out of gratitude.

Examine the case in t h e light of code of professional misconduct.

Answer

Clause (1) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him.

The above clause is intended to safeguard the public against unqualified accountant practicing under the cover of qualified accountants. It ensures that the work of the accountant will be carried out by a Chartered Accountant who may be his partner, or his employee and would work under his control and supervision.

In the instant case, CA Pant allowed CA Sant (who is a newly qualified CA professional with COP) to sit in his office for 6 months, and allowed him to provide tax consultancy independently to his firm's clients, filing of some IT and GST Returns. He also allowed him to appear before various tax authorities on behalf of his firm. CA Sant was only reimbursed with his usual expenses and was not paid any salary or share of profit for the same. However, after the end of agreed period he was given a lump-sums of rupees 3,00,000 for his association out of gratitude.

Thus, in the present case CA. Pant will be held guilty of professional misconduct as per Clause (1) of Part I of First Schedule to the Chartered Accountants Act, 1949 as he allowed CA Sant to practice in his name as Chartered accountant and CA Sant is neither in partnership nor in employment with CA. Pant.

Question 20

Ms. Preeti is a practicing Chartered Accountant. Mr. Preet is a practicing Advocate representing matters in the court of law. Ms. Preeti and Mr. Preet decided to help each other in the matters involving their professional expertise. Accordingly, Ms. Preeti recommends Mr. Preet in all tax litigation matters in the court of law and Mr. Preet consults Ms. Preeti in all matters related to finance and other related matters, which comes to him in arguing various cases in the court of law. Consequently, they started sharing some part in the profits of their professional work.

Answer

Sharing and Accepting of Part of Profits with an Advocate: According to Clause (2) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional

business, to any person other than a member of the Institute, for the purpose of rendering such professional services from time to time in or outside India.

Furthermore, Clause (3) of Part I of the First Schedule to the said Act states that a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he accepts any part of the profits of the professional work of a person who is not a member of the Institute.

However, a practicing member of the Institute can share fees or profits arising out of his professional business with such members of other professional bodies or with such other persons having such qualifications as prescribed by the Council under Regulation 53 -A of the Chartered Accountants Regulations, 1988. Under the said regulation, the member of "Bar Council of India" is included.

Therefore, Mr. Preet, an advocate, a member of Bar Council, is allowed to share part of profits of his professional work with Ms. Preeti. Hence, Ms. Preeti, a practicing Chartered Accountant, will not be held guilty under any of the abovementioned clauses for paying and accepting part of profits from Mr. Preet.

Question 21

Mr. X who passed his CA examination of ICAI on 18th July, 2019 and started his practice from August 15, 2019. On 16th August 2019, one female candidate approached him for articleship. In addition to monthly stipend, Mr. X also offered her 1 % profits of his CA firm. She agreed to take both 1 % profits of the CA firm and stipend as per the rate prescribed by the ICAI. The Institute of Chartered Accountants of India sent a letter to Mr. X objecting the payment of 1 % profits. Mr. X replies to the ICAI stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the financial position of the articled clerk is very weak. Is Mr. X Liable to professional misconduct?

Answer

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

In view of the above, the objections of the Institute of Chartered Accountants of India, as given in the case, are correct and reply of Mr. X, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk as the position of the articled clerk is weak is not tenable.

Hence, Mr. X is guilty of professional misconduct in terms of Clause (2) of Part I of First Schedule to the Chartered Accountants Act 1949.

Question 22

Mr. K, a practicing Chartered Accountant gave 50% of the audit fees received by him to a non-Chartered Accountant, Mr. L, under the nomenclature of office allowance and such an arrangement continued for a number of years.

Answer

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

In the instant case, Mr. K, a practising Chartered Accountant gave 50% of the audit fees received by him to a non-Chartered Accountant, Mr. L, under the nomenclature of office allowance and such an arrangement continued for a number of years. In this case, it is not the nomenclature to a transaction that is material but it is the substance of the transaction, which has to be looked into.

The Chartered Accountant had shared his profits and, therefore, Mr. K will be held guilty of professional misconduct under the Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 23

Mr. Qureshi, Chartered Accountant, in practice died in a road accident. His widow proposes to sell the practice of her husband to Mr. Pardeshi, Chartered Accountant, for ₹ 5 lakhs. The price also includes right to use the firm name – Qureshi and Associates. Can widow of Qureshi sell the practice and can Mr. Pardeshi continue to practice in that name as a proprietor?

Answer

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

It lay down that the sale is permitted subject to certain conditions discussed in above diagram. It further resolved that the legal heir of the deceased member has to obtain the permission of the Council within a year of the death of the proprietor concerned.

Conclusion: Thus, in a given case and on the facts, the widow of Mr. Qureshi, who has sold the practice for ₹ 5 lakhs is nothing but sale of goodwill. Thus the act of Mrs. Qureshi is permissible.

Question 24

Mr. Q a Chartered Accountant in practice as a proprietor died in a road accident. His widow sold the practice of her husband to another Chartered Accountant in practice for ₹ 5 lakhs. The price also included right to use the firm name of Mr. Q.

Answer

Sale of Goodwill: The Council of the Institute considered the issue whether the goodwill of a proprietary firm of chartered accountant can be sold/transferred to another eligible member of the Institute, after the death of the proprietor concerned and came to the view that the same is permissible. The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30/8/1998, the

goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed upto a period of one year from the death of the proprietor. Thus, in the instant case, when the widow of Mr. Q sells the practice to another member, it is nothing but goodwill sold to another member. The sale of the practice and the right to use the name is also allowed in terms of the above decision of the Council. Thus the above act of the widow of Mr. Q is permissible.

Question 25

A Chartered Accountant who was in practices since last 20 years died in a road accident. His widow sold the practice to another Chartered Accountant in practice for ₹ 30 lakhs. The price also included the right to use the firm name.

Answer

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

The Council resolved that the sale/transfer of goodwill in the case of a proprietary firm of chartered accountant to another eligible member of the Institute shall be permitted. It further laid down that in cases where the death of proprietor occurs after 30.08.1998, the goodwill of the deceased member's practice can be sold to another member and permission of the Institute has to be obtained within a year of the death of the proprietor concerned. It is even laid down that in such cases the name of the proprietary firm concerned would not be removed up to a period of one year from the death of the proprietor.

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

Question 26

CA. P is a newly qualified Chartered Accountant in practice and in order to increase his professional practice and client base, entered into an agreement with Mr. A, a qualified and experienced registered valuer, to share 20% professional fees for all cases of valuation referred to him by CA. P. Based on this, CA. P received ₹ 1,20,000 during the year 2019-20 from Mr. A. Is CA. P guilty of misconduct under the Chartered Accountants' Act, 1949?

Answer

Sharing Professional Fees with Registered Valuer: As per Clause (3) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant will be guilty of professional misconduct if he accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute.

A member cannot share his fees with a non-member similarly he is also not permitted to receive and share the fees of others except for sharing with Member of such professional body or other person having such qualification as may be prescribed (Regulation 53A of the Chartered Accountants Regulations, 1988) by the Council. Under the Regulation 53-A of the Chartered Accountants Regulations, 1988, registered valuer is not included.

In the instant case Mr. P, who is a newly qualified Chartered Accountant in practice entered into an

agreement with Mr. A, a qualified and experienced registered valuer, to share 20% professional fees for all case of valuation referred to him by CA. P. CA. P also received rupees 1,20,000 for the same from Mr. A. Thus, CA P will be held guilty for misconduct under clause (3) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 27

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.

Answer

Partnership with an Advocate: 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 a broad would be titled to be registered as a member under Clause(v)of Sub-section (1) of Section 4 or whose qualification are recognized by the Central Government or the Council for the purpose of permitting such partnership.

However, Regulation 53B of the Chartered Accountants Regulations, 1988 permits a Chartered Accountant in practice to enter into partnership with other prescribed Professionals which includes an Advocate, a member of Bar Council of India.

In the instant case, Mr. P, a chartered accountant, has entered into partnership with Mr. L, an advocate.

Thus, he would not be guilty of professional misconduct as per Clause (4) of Part I of First Schedule read with Regulation 53B.

Question 28

A Chartered Accountant having CoP entered into partnership with persons, who are not the members of the institute, for the purpose of carrying on business. The share of the chartered account in the profit and losses was 25%. He was to take part in the business and was entitled to represent the firm before Govt. authorities etc. He was operating the bank account of the firm, was receiving moneys from the customers and was also looking after the affairs of the Partnership.

Answer

Practicing CA Entering into Partnership and Carrying on Business: As per Clause (4) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he enters into partnership, in or outside India, with any person other than Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

It may be noted that the Council has prescribed the list of person qualified and the professional bodies for the purpose of entering into partnership under the Chartered Accountants Regulations, 1988.

Further, according to Clause (11) of Part I of First Schedule to the said Act, a Chartered

Accountant in practice shall be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

It may also be noted that a member in practice is required to apply for specific and prior approval of the Council for entering into any business.

In the given case, a chartered accountant in practice has entered into partnership with persons who were not the members of the Institute, for the purpose of carrying on business.

The question is silent about with whom the partnership has been entered into and whether the prior permission for entering into such business has been obtained.

Conclusion: It is assumed that the persons with whom the partnership has been entered into has not been allowed under the Regulations and the prior approval of the Council has not been obtained for entering into such business. Hence, the Chartered Accountant shall be held guilty of professional misconduct under Clause (4) and Clause (11).

Question 29

A Chartered Accountant practising in India enters into partnership with

- (a) A Certified Public Accountant in New York.
- (b) A Chartered Accountant from the Institute of Chartered Accountants in England and Wales in London, and in each case, the members concerned take the profits earned in their own country.

Answer

- (a) **Partnership with a CPA in New York:** Clause (4) of Part I to the First Schedule to the Chartered Accountants Act, 1949 specifies that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he enters into partnership, in or outside India, with any person other than a chartered accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships;
Thus, chartered accountant would be guilty of professional misconduct since certified public accountants (CPA) are not eligible to become members of the Institute.
- (b) **Partnership with a chartered accountant from ICAEW:** As stated above, it is important that partnership with a member of the foreign professional body is permissible provided *inter alia* such bodies are eligible for the membership of the Institute. Earlier, the Council had passed a resolution permitting chartered accountants from ICAEW to become members of the Institute as also fulfilment of certain conditions in respect of persons not permanently residing in India. However, the Council of the Institute at its meeting held in December, 1995 decided to withdraw the resolution w.e.f. December 8, 1995. In view of this, persons qualified from any of the four Institutes in the United Kingdom including England and Wales are not entitled to have their names entered in the Register of Members maintained by the Institute effective from December 8, 1995. Based on this development, partnership between members of the Institute and members of above foreign professional bodies will not be permissible from the above date. Even a chartered accountant from ICAEW who was eligible to become member of the Institute, the profit sharing arrangement stated in the question goes against the provisions of Clause (4). Hence, it would constitute professional misconduct.

Question 30

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.

Answer

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 practiced so that members may 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.

Question 31

M/s XYZ, a firm in practice, develops a website “xyz.com”. The colour chosen for the website was a very bright green and the web-site was to run on a “push” technology where the names of the partners of the firm and the major clients were to be displayed on the web-site without any disclosure obligation from any regulator.

Answer

Posting of Particulars on Website: The Council of the Institute had approved posting of particulars on website by Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 subject to the prescribed guidelines. The relevant guidelines in the context of the website hosted by M/s XYZ are:

- ◆ No restriction on the colours used in the website;
- ◆ The websites are run on a “pull” technology and not a “push” technology
- ◆ Names of clients and fees charged not to be given.

However, disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that “This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/area where such regulator has jurisdiction] vide [Rule/ Directive etc. under which the disclosure is required by the Regulator].

In view of the above, M/s XYZ would have no restriction on the colours used in the website but failed to satisfy the other two guidelines. Thus, the firm would be liable for professional misconduct since it would amount to soliciting work by advertisement.

Question 32

XYZ, a firm of Chartered Accountants created a website “www.xyzindia.com”. The website besides containing details of the firm and bio-data of the partners also contains the passport size photographs of all the partners of the firm.

Answer

Hosting Details on Website: As per detailed guidelines of the ICAI laid down in Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant of the firm can create its own website using any format subject to guidelines. However, the website should be so designed that it does not solicit clients or professional work and should not amount to direct or indirect advertisement. The guidelines of the ICAI to allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph. In the case of M/s XYZ, all the guidelines seem to have been complied and there appears to be no violation of the Chartered Accountants Act, 1949 and its Regulations.

Question 33

Z, a Chartered Accountant wrote several letters to Government Department, pointing out seniority of his firm, sending his life sketch and stating that he had a glorious record of service to the country as well as to the organization of accountancy profession with a view to get the audit work.

Answer

Solicitation of Professional Work Through Letters: ‘Z’ a chartered accountant, wrote several letters to Government Department pointing out the seniority of his firm and sending his life sketch and stating that he had rendered glorious service to the country and to the accountancy profession with a view to getting the audit work. Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949 prohibits a member not to solicit professional work by means of advertisement, circular, personal communication or interview or by any other means. Since these letters were clearly in the nature of advertising professional attainments, “Z” was guilty of professional misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 34

M, a practicing Chartered Accountant sent a letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had given a list of his existing clients and details of his staff etc.

Answer

Soliciting Work Directly or Indirectly: As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a member shall be held guilty if a Chartered Accountant in practice solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Further, as per Central Council Guidelines for Advertisement for the members in practice, write up of the members should not claim superiority over any other Member(s)/Firm(s) and should

also not include the names of the clients.

In the present case, Mr. M, a practicing Chartered Accountant sent the letter to another firm of Chartered Accountants, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had also given a list of his existing clients and details of his staff etc. which seems to be indirect methods to adventure their professional practice with a view to gain publicity and thereby solicit clients or professional work.

Hence, Mr. M was guilty of professional misconduct as per Clause (6) of Part I of First Schedule of the Chartered Accountants Act, 1949.

Question 35

A partner of a firm of chartered accountants during a T.V. interview handed over a bio -data of his firm to the chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated. It also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the said bio-data during the interview. Discuss whether this action by the Chartered Accountant would amount to misconduct or not.

Answer

Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits solicitation of client or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means since it shall constitute professional misconduct. The bio-data was handed over to the chairperson during the T.V. interview by the Chartered Accountant which included details about the firm and the achievements of the partner as an expert in the field of taxation. The chairperson simply read out the same in detail about association with the international firm as also the achievements of the partner and his recognition as an expert in the field of taxation. Such an act would definitely lead to the promotion of the firms' name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. The partner would be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 36

The offer document of a listed company in which Mr. D, a practising Chartered Accountant is a director mentions the name of Mr. D as a director along with his various professional attainments and spheres of specialisation.

Answer

The Council of the ICAI has in a communication to members stated that if a public company, in which a chartered accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field, it shall constitute a misconduct under Clauses (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members. Thus in the instant case, Mr. D would be held to be guilty of professional misconduct and liable for disciplinary action.

Question 37

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.

Answer

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.

Question 38

XYZ & Associates, a firm with 5 partners developed a website www.xyzassociates.com. The website also contained a link to “All India Chartered Accountants Association”, a voluntary association where X, a partner of the firm is currently the Vice-president.

Answer

Developing Website: As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to “All India Chartered Accountants Association” which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 39

M/s LMN, a firm of Chartered Accountants responded to a tender from a State Government for computerization of land revenue records. For this purpose, the firm also paid ₹50,000 as earnest deposit as part of the terms of the tender.

Answer

Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit 50,000 as

earnest deposit and shall not have committed any professional misconduct.

Question 40

An advertisement was published in a Newspaper containing the photograph of Mr. X, a member of the institute wherein he was congratulated on the occasion of the opening ceremony of his office.

Answer

Publishing an Advertisement Containing Photograph: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X published an advertisement in a Newspaper containing his photograph on the occasion of the opening ceremony of his office. On this context, it may be noted that the advertisement which had been put in by the member is quite prominent. If soliciting of work is allowed, the independence and forthrightness of a Chartered Accountant in the discharge of duties cannot be maintained.

The above therefore amounts to soliciting professional work by advertisement directly or indirectly. Mr. X would be therefore held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 41

Mr. X, a Chartered Accountant and the proprietor of X & Co., wrote several letters to the Assistant Registrar of Co-operative Societies stating that though his firm was on the panel of auditors, no audit work was allotted to the firm and further requested him to look into the matter.

Answer

Soliciting Professional Work: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

In the given case, Mr. X, a Chartered Accountant and proprietor of M/s X and Co., wrote several letters to the Assistant Registrar of Co-operative Societies, requesting for allotment of audit work. In similar cases, it was held that the Chartered Accountant would be guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949. The writing of continuous letter to ascertain the reasons for not getting the work is quite alright but in case such either amount to request for allowing the work then Mr. X will be liable for professional misconduct.

Consequently, Mr. X would therefore be held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 42

PQR and Associates, Chartered Accountants have their website and on the letterhead of the firm it is mentioned that "Visit our website: PQR com". In the website, the nature of assignments

handled, name of prominent clients and fees charged are also displayed without any disclosure obligation from any regulator.

Answer

The Council of the Institute of Chartered Accountants has issued guidelines for posting the particulars on Website by Chartered Accountants in practice and firms of Chartered Accountants in practice under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949. According to the guidelines the details in the website should be so designed that it does not amount to soliciting client or professional work. It is permitted to mention the website address on letterhead but soliciting people to visit website is not permitted. Nature of assignments handled (to be displayable only on specific “pull” request) may be allowed to be displayed on the Websites but Name of clients and fee be charged cannot be given.

However, disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. Where such disclosure of names of clients and/or fees charged is made on the website, the member/ firm shall ensure that it is mentioned on the website [in italics], below such disclosure itself, that “This disclosure is in terms of the requirement of [name of the regulator] having jurisdiction in [name of the country/area where such regulator has jurisdiction] vide [Rule/Directive etc. under which the disclosure is required by the Regulator].

In the given case, PQR and Associates letterhead invites to people to visit their website. Similarly the website mentions the nature of assignments, names of the prominent clients and fees charged. The nature of assignments is permitted for display only on specific 'Pull' request. And the name of clients, the fees charged is not permitted unless required by regulator.

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

Question 43

A letter is sent by a Chartered Accountant in practice to the Ministry of Finance inquiring whether a panel of auditors is being maintained by the Ministry and if so to include his name in the panel (CV enclosed).

Answer

Making Roving Inquiries: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgement and may be able to command respect from their prospective clients.

In case of making an application for the empanelment for the allotment of audit and other professional work, the Council has opined that, “where the existence of such a panel is within the knowledge of the member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the member to make roving inquiries by applying to any such organization for having his name included in any such panel.”

Accordingly, the member is guilty of misconduct in terms of the above provision as he has solicited professional work from the Finance Ministry, by inquiring about the maintenance of the panel.

Question 44

Mr. Honest, a Chartered Accountant in practice, wrote two letters to M/s XY Chartered Accountants a firm of CAs; requesting them to allot him some professional work . As he did not have a significant practice or clients he also wrote a letter to M/s ABC, a firm of Chartered Accountants for securing professional work. Mr. Clever, an another CA, informed ICAI regarding Mr Honest's approach to secure the professional work. Is Mr. Honest wrong in soliciting professional work?

Answer

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

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

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

Question 45

Mr. Nigal, a Chartered Accountant in practice, delivered a speech in the national conference organized by the Ministry of Textiles. While delivering the speech, he told to the audience that he is a management expert and his firm provides services of taxation and audit at reasonable rates. He also requested the audience to approach his firm of chartered accountants for these services and at the request of audience he also distributed his business cards and telephone number of his firm to those in the audience. Comment.

Answer

Using Designation Other Than a CA and Providing Details of Services Offered: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgment and may be able to command respect from their prospective clients.

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

title indicating membership of any other professional body recognised by the Central Government or the Council.

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

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

Question 46

CA. N, in practice, started project consultancy work as a part of his practice and to advance the same, sent mail to all the CAs in the country informing them of his services and for securing professional work.

Answer

As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he solicit clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

However, nothing herein contained shall be construed as preventing or prohibiting, any chartered accountant from applying or requesting for or inviting or securing professional work from another chartered accountants in practice.

In the instant case, CA. N has written email to all the CA for securing professional work from them and has not approached any other person or professional or communicated with any client, Thus as per exception to the Clause (6), CA. N is well within the regulation of the act and has not committed any professional misconduct.

Question 47

A special notice has been issued for a resolution at 3rd annual general meeting of Fiddle Ltd. providing expressly that CA. Smart shall not be re-appointed as an auditor of the company. Consequently, CA. Smart submitted a representation in writing to the company as provided under section 140(4)(iii) of the Companies Act, 2013. In the representation, CA. Smart incorporated his independent working as a professional throughout the term of office and also indicated his willingness to continue as an auditor if reappointed by the shareholders of the Company.

Answer

Soliciting Clients: As per Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means except applying or requesting for or inviting or securing professional work from another chartered accountant in practice and

responding to tenders.

Further, section 140(4)(iii) of the Companies Act, 2013, provides a right, to the retiring auditor, to make representation in writing to the company. The retiring auditor has the right for his representation to be circulated among the members of the company and to be read out at the meeting. However, the content of letter should be set out in a dignified manner how he has been acting independently and conscientiously through the term of his office and may, in addition, indicate, if he so chooses, his willingness to continue as auditor, if re-appointed by the shareholders.

Thus, the incorporation as an independent professional, made by CA. Smart, while submitting representation under section 140(4)(iii) of the Companies Act, 2013 and indication of willingness to continue as an auditor if reappointed by shareholders, does not leads to solicitation.

Therefore, CA. Smart will not be held guilty for professional misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 48

CA. Intelligent, a Chartered Accountant in practice, provides part-time tutorship under the coaching organization of the Institute. On 30th June, 2019, he was awarded 'Best Faculty of the year' as gratitude from the Institute. Later on, CA. Intelligent posted his framed photograph on his web site where in he was receiving the said award from the Institute.

Answer

Posting Photograph on Website: A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

In the given case, CA. Intelligent shared his framed photograph on website wherein he was receiving 'Best Faculty of the year' award from the Institute.

In this context, it may be noted that according to the guidelines approved by the Council of the Institute of Chartered Accountants of India, no photographs of any sort are permitted. Only display of passport size photograph is permitted.

Therefore, CA. Intelligent is guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 49

Mr. Raj, a renowned practicing Chartered Accountant, decided to tie his knot with Ms. Anjani. While giving order for marriage invitation cards, Mr. Raj instructed to add his designation "Chartered Accountant" with his name. Later on, the cards were distributed to all his relatives, close friends and clients.

Answer

Printing of Designation "Chartered Accountant" on Marriage Invitations: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

However, the Council of the ICAI is of the view that the designation "Chartered Accountant" as well as the name of the firm may be used in greeting cards, invitations for marriages and religious

ceremonies and any other specified matters, provided that such greeting cards or invitations etc. are sent only to clients, relatives and close friends of the members concerned.

In the given case, Mr. Raj instructed to write designation “Chartered Accountant” on his marriage invitation cards and distributed the same to all his relatives, close friends and clients.

On this context, it may be noted that the Council has allowed using designation “Chartered Accountant” in invitations for marriages, provided these are sent only to clients, relatives and close friends of the members concerned. Therefore, Mr. Raj would not be held guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 50

CA. Srishti and CA. Mishti are two partners of the CA firm ‘Srishti Mishti & Associates’. Being very pious, CA. Srishti organised a religious ceremony at her home for which she instructed her printing agent to add her designation “Chartered Accountant” with her name in the invitation cards. Later on, the invitations were distributed to all the relatives, close friends and clients of both the partners.

Answer

Printing of Designation “Chartered Accountant” on Invitations for Religious Ceremony: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

However, the Council of the ICAI is of the view that the designation “Chartered Accountant” as well as the name of the firm may be used in greeting cards, invitations for marriages, religious ceremonies and any other specified matters, provided that such greeting cards or invitations etc. are sent only to clients, relatives and close friends of the members concerned.

In the given case, CA. Srishti has instructed to write designation “Chartered Accountant” on invitation cards for a religious ceremony and distributed the same to all the relatives, close friends and clients of both the partners.

In this context, it may be noted that the Council has allowed using designation “Chartered Accountant” in invitations for religious ceremony, provided these are sent to clients, relatives and close friends of the members concerned only.

Therefore, CA. Srishti would be held guilty of professional misconduct under the said clause for sending such invitations to the relatives, close friends and clients of CA. Mishti as well.

Question 51

Mr. Brilliant, a chartered accountant in practice, created his own website in attractive format and highlighted the contents in blue colour. He also circulated the information contained in the website through E-mail to acknowledge public at large about his expertise. However, due to shortage of time, he could not intimate his website address to the Institute.

Answer

Circulating Information Contained in Own Website: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or

indirectly by circular, advertisement, personal communication or interview or by any other means.

However, the guidelines approved by the Council of the Institute of Chartered Accountants of India permit 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.

Further, members are not required to intimate the Website address to the Institute. Members are only required to comply with the Website Guidelines issued by the Institute in this regard.

In the given case, Mr. Brilliant has circulated the information contained in the website through E-mail to public at large. Therefore, he is guilty of professional misconduct under Clause (6) of Part I of the First Schedule to the said Act. However, there is no such misconduct for not intimating website address to the Institute.

Question 52

OPAQ & Associates, a firm of Chartered Accountants responded to a tender issued exclusively for Chartered Accountants by an organisation in the area of tax audit. However no minimum fee was prescribed in the tender document.

Answer

Responding to Tenders: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. It states that a member may respond to tenders or enquiries issued by various users of professional services or organizations from time to time and secure professional work as a consequence.

However, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for Chartered Accountants, such as audit and attestation services. Though, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants.

In the instant case, OPAQ & Associates responded to a tender of tax audit which is exclusively reserved for Chartered Accountants even though no minimum fee was prescribed in the tender document.

Therefore, OPAQ & Associates shall be held guilty of professional conduct for responding to such tender in view of above-mentioned guideline.

Question 53

During the opening ceremony of a new branch office of CA. Young, his friend CA. Old introduced to CA. Young, his friend and client Mr. Rich, the owner of an Export House whose accounts had been audited by CA. Old for more than 15 Years. After few days, Mr. Rich approached CA. Young and offered a certification work which hitherto had been done by CA. Old. CA. Young undertook the work for a fee which was not less than fee charged by CA. Old in earlier period. Comment whether CA. Young had done any professional misconduct.

Answer

Acceptance of original professional work by a member emanating from the client

Introduced to him by another member: As per Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means.

Further, some forms of the soliciting work which the Council has prohibited include that a member should not accept the original professional work emanating from a client introduced to him by another member. If any professional work of such client comes to him directly, it should be his duty to ask the client that he should come through the other member dealing generally with his original work.

In the given case, CA Old introduced his friend CA. Young to his friend and client Mr. Rich, the owner of an Export House whose accounts has been audited by CA. Old for more than 15 years. After a few day Mr. Rich approached CA. Young and offered a certification work which hitherto had been done by CA. Old. Fees charged by CA. Young is also not less than fee charged by CA. Old.

In view of above decision CA Young should ask the client to come through CA Old. However, CA Young undertook the work without informing CA. Old. Thus, CA. Young is held guilty under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 54

Mr. A, a newly qualified Chartered Accountant, started his practice and sought clients through telephone calls from his family and friends, almost all of them employed in one or the other retail trade business. One of his friends Mr. X gave him an idea to start online services and give stock certifications to traders with Cash Credit Limits in Banks. Mr. A started a website with colorful catchy designs and shared the website address on his all social media posts and stories and tagged 30 traders of his local community with the caption “Easy Online Stock Certification Services”. Besides, Mr. A entered in an agreement with a Digital Marketer to give him 5% commission on each service procured through him. Discuss if the actions of Mr. A are valid in the light of the Professional Ethics and various pronouncements and guidelines issued by ICAI.

Answer

As per Clause (6) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

Mr. A is wrong in seeking clients through family and friends. Creating a website is not a non-compliance provided it is in line with the guidelines issued by the Institute in this regard. One of the guidelines is that the website should not be in push mode. Further, mentioning of clients' names is also prohibited as per the guidelines.

In the given situation, Mr. A shared the website address on his all social media posts and stories and tagged 30 traders of his local community with the caption “Easy Online Stock Certification Services” mentioning his current clients as well. This is in complete contravention of the guidelines on website issued by the ICAI.

Thus, CA, A would be held guilty of professional misconduct under clause 6 of Part 1 of First Schedule of the Chartered Accountants Act, 1949.

Question 55

Mr. B, a practicing Chartered Accountant as well as a qualified lawyer, was permitted by the bar council to practice as a lawyer also. He printed his visiting card where he mentioned his designation as Chartered Accountant and Advocate.

Answer

Using Designation of CA and Advocate Simultaneously: Under Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant' on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

This clause prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public.

Members of the Institute in practice who are otherwise eligible may practice as advocates subject to the permission of the Bar Council but in such case, they should not use designation 'chartered accountant' in respect of the matters involving the practice as an advocate. In respect of other matters they should use the designation 'chartered accountant' but they should not use the designation 'chartered accountant' and 'advocate' simultaneously. Since Mr. B has printed his visiting card where he mentioned his designation as Chartered Accountant and Advocate which is prohibited under the above clause and hence Mr. B is guilty of professional misconduct.

Question 56

Mr. SP, a Chartered Accountant, obtains registration as category IV Merchant Banker under the SEBI's Rules and Regulations and act as Advisor to a capital issue of MB Co. Ltd. He designates himself under the caption "Merchant Banker" in client offer documents and 'Advisor to issue' in his own letterheads, visiting cards and professional documents.

Answer

Use of Designation other than Chartered Accountant: Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949 restrains a Chartered Accountant in practice from advertising his professional attainments or services. It also prohibits a member from using any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or of any other institution that has been recognized by the Central Government or may be recognized by the Council.

It may be noted that, in Client Companies' offer documents and advertisements regarding capital issue, name and address of the Chartered Accountant acting as Advisor or Consultant to the Issue could be indicated under the caption "Advisor/ Consultant to the Issue". Further, such members

should not use the designation of either 'Merchant Banker' or 'Advisor/Consultant to Issue' in their own letterheads, visiting cards, professional documents, etc.

In the given case, Mr. SP, a Chartered Accountant, has obtained registration as category IV Merchant banker and acted as advisor to a capital issue of MB Co. Ltd. He has designated himself under the caption "Merchant Banker" in client offer documents and "advisor to issue" in his own letterheads, visiting cards and professional documents.

Therefore, Mr. SP shall be held guilty of professional misconduct as per Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 57

A practising Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as

- (a) Tax Consultant
- (b) Cost Accountant.

Answer

(a) Tax Consultant: Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public. Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council. Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

(b) Cost Accountant: As stated in the preceding paragraph, this would also constitute misconduct under section 7 of the Act read with Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949. A chartered accountant in practice cannot use any other designation than that of a chartered accountant. Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies which have been approved by the Council. Thus, it is improper for a chartered accountant to state in his documents that he is a "Cost Accountant". However as per the Chartered Accountants Act, 1949, the Council has resolved that the members are permitted to use letters indicating membership of the Institute of Cost and Works Accountants but not the designation "Cost Accountant".

Question 58

A practicing Chartered Accountant uses a visiting card in which he designates himself, besides as Chartered Accountant, as a Tax Consultant

Answer

Tax Consultant: Section 7 of the Chartered Accountants Act, 1949 read with Clause (7) of Part I

of the First Schedule to the said Act prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a chartered accountant in documents through which the professional attainments of the member would come to the notice of the public.

Under the clause, use of any designation or expression other than chartered accountant for a chartered accountant in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognised by the Central Government or the Council.

Conclusion: Thus, it is improper to use designation "Tax Consultant" since neither it is a degree of a University established by law in India or recognised by the Central Government nor it is a recognised professional membership by the Central Government or the Council.

Question 59

B, a Chartered Accountant in practice is a partner in 3 firms. While printing his personal letter heads, B gave the names of all the firms in which he is a partner.

Answer

Advertisement of Professional Attainments: Clause (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm on letterheads. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner.

Conclusion: Thus, B is not guilty of any misconduct under the Chartered Accountants Act, 1949

Question 60

A Chartered Accountant in practice, empanelled as IP (Insolvency Professional) has mentioned the same on his visiting cards, letter heads and other communications also. Mr. A, who is residing in his neighbourhood has filed a complaint for professional misconduct against the said member for such mention of insolvency professional on circulations.

Answer

As per the Clause 7 of Part 1 of the First Schedule, if any Chartered Accountant advertises his professional attainments or services, or uses any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognised by the Central Government or a title indicating membership of the ICAI or any other institution that has been recognized by the Central Government or may be recognized by the council, will be guilty of professional misconduct.

Here A Chartered Accountant empanelled as IP (Insolvency Professional) can mention 'Insolvency Professional' on his visiting cards, Letter heads and other communication, as this is a title recognised by the Central Government in terms of Clause-7 of Part-1 of First Schedule to the

Question 61

Mr. M, a Chartered Accountant in practice, has printed visiting cards which besides other details also carries a Quick Response (QR) code. The visiting card as well as the QR code contains his name, office and residential address, contact details, e-mail id and name of the firm's website.

Answer

Printing of QR Code on Visiting Cards: As per Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he advertises his professional attainments or services.

Ethical Standards Board has also clarified that a member in practice is allowed to print Quick Response Code (QR Code) on the visiting Card, provided that the Code does not contain information that is not otherwise permissible to be printed on a visiting Card.

In the given case, Mr. M has printed visiting cards which carries Quick Response Code (QR Code) besides other details. The visiting card as well as the QR Code contains his name, office and residential address, contact details, e-mail id and name of the firm's website which are otherwise allowed to be printed on the visiting cards of a Chartered Accountant in practice.

Thus, Mr. M is not guilty under Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Chartered Accountants Act, 1949. Thus, complaint of neighbour is not enforceable/valid.

Question 62

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.

Answer

Failure to Communicate with the Previous Auditor: 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.

Question 63

CA. T, in practice, was appointed to carry out internal audit of a stock broker, listed with BSE. However, he failed to intimate his appointment to the statutory auditors of the company. The statutory auditor feels this is violation of professional ethics.

Answer

As per Clause (8) of Part I of First Schedule to the Chartered Accountants 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 Certificate Rules, 1932 without first communicating with him in writing.

This clause is applicable in situation of replacing of one auditor by another auditor. Internal auditor and statutory auditor are parallel positions and not replacement positions. The management generally appoints the internal auditor whereas the statutory auditor will be appointed by the shareholders in the AGM. In this situation there is no need for communication by one to other.

In view of above the contention of the statutory auditor is unacceptable and there is no question of communicating in writing by Mr. T.

Question 64

Mr. X, a Chartered Accountant accepted his appointment as tax auditor of a firm under Section 44AB, of the Income-tax Act, and commenced the tax audit within two days of his appointment since the client was in a hurry to file Return of Income before the due date. After commencing the audit, Mr. X realised his mistake of accepting this tax audit without sending any communication to the previous tax auditor. In order to rectify his mistake, before signing the tax audit report, he sent a registered post to the previous auditor and obtained the postal acknowledgement. Will Mr. X be held guilty under the Chartered Accountants Act?

Answer

Communication with the Previous Auditor: As per Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. X will be held guilty since he has accepted the tax audit, without first communicating with the previous auditor in writing. The object of the incoming auditor communicating in writing with the retiring auditor is to ascertain whether there are any circumstances which warrant him not to accept the appointment, for example, whether the previous auditor has been changed on account of having qualified the report or he had expressed a wish not to continue on account of something inherently wrong with the administration of the business. The retiring auditor may even give out information regarding the condition of the accounts of the client or the reason that impelled him to qualify his report. Under all circumstances, it would be essential for the incoming auditor to carefully consider the facts before deciding whether or not he should accept the audit. As a matter of professional courtesy and professional obligation it is necessary for the new auditor appointed to communicate with such earlier auditor.

Question 65

W, a Chartered Accountant has sent letters under certificate of posting to the previous auditor informing him his appointment as an auditor before the commencement of audit by him.

Answer

Communication with the Previous Auditor: Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949 requires communication by the incoming auditor with the previous auditor before accepting a position by him. The Council of the Institute has taken the view that a mere posting of a letter “under certificate of posting” is not sufficient to establish communication with the retiring auditor unless there is some evidence to show that the letter has in fact reached the person communicated with. A Chartered Accountant who relies solely upon a letter posted “under certificate of posting” therefore does so at his own risk. Since the letters were sent by “W” to the previous auditor informing him of his appointment as an auditor before the commencement of audit by him under Certificate of Posting is not sufficient to prove

communication with the retiring auditor. In the opinion of the Council, communication by a letter sent "Registered Acknowledgement Due" or by hand against a written acknowledgement would in the normal course provide positive evidence.

Conclusion: Hence "W" was guilty of professional misconduct under Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949

Question 66

XYZ Ltd. appoints you as the auditor of the company. You observe that previous auditors A & Co., resigned. Also Balance Sheet as at 31-03-2016 shows an audit fee payable of ₹ 25,000. What precautions you will take before commencing the audit work?

Answer

Precautions before Commencing the Audit Work: In the instant case, before accepting the appointment as well as commencing the audit work, the auditor should see the following -

- (i) Check whether a statement, in the prescribed form, has been filed by the resigning auditor within a period of 30 days from the date of resignation, to the company and the registrar (or the Comptroller and Auditor-General of India, as the case may be), indicating the reasons and other facts as may be relevant with regard to the resignation, for the compliance of Section 140(2) of the Companies Act, 2013 (herein after referred as the Act).
- (ii) Ascertain that the appointment of new Auditor is in compliance with Section 139(8) of the Act as mentioned above i.e. the resolution appointing the new auditor has been approved by the company in the general meeting as in the case of casual vacancy by resignation.
- (iii) The auditor must obtain the NOC from previous auditor. He should also refer the resignation statement file by the previous auditor and communicate with him (previous auditor) to ascertain the circumstances which led up him to retire.
- (iv) The auditor must ascertain whether there existed any circumstances on account of which he should not accept the appointment.
- (v) As per Section 139 of the Act, the auditor must ensure that before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate has been provided by him to the company that his appointment is in accordance with the limits specified in Section 141(3)(g).
- (vi) He should also satisfy himself that the notice provided for under Sections 139 and 140 has been effectively served on the outgoing auditor.

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing. Moreover, Clause (9) of Part I of the same Schedule, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Question 67

P, a Chartered Accountant in practice, accepts appointment as statutory auditor for LMN Pvt. Ltd. Q, brother of P has substantial interest in LMN Pvt. Ltd.

Answer

Accepting Appointment as an Auditor where Relative Holding Substantial Interest: Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Further, as per Section 141(3)(d)(i) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company who, or his relatives or partner is holding any security of or interest in the company.

In the instant case, since Q, a relative has a substantial interest in LMN Pvt. Ltd., P cannot conduct the audit and needs to vacate the office. Thus, P will be guilty of misconduct in terms of above clause.

Question 68

Mrs. Fair is a Director of XYZ Private Limited, having 15% share-holdings in the company. During 2019, the company appointed C.A. Mr. Lovely, Mrs. Fair's spouse, as its statutory auditor. On Mr. Lovely's advice, the company issued fresh equity shares in 2019-20, in the ratio of one share for every two shares held by the shareholders of the company. Mr. Lovely used to deliver audit report for subsequent years without any comments or disclosures, thereupon.

Answer

Expressing an Opinion on Financial Statements where Director is a Relative: Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

As per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel. The definition of 'Relative' includes husband and wife.

In this case Mrs. Fair is a Director of XYZ Private Limited and the company has appointed Mr. Lovely, Chartered Accountant, Mrs. Fair's spouse, as its statutory auditor. Mr. Lovely should not accept the appointment as statutory auditor of the company, where his wife Mrs. Fair is director. This is contravention of section 141(3)(f) of the Companies Act, 2013.

Therefore, Mr. Lovely is liable for misconduct as per Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 69

CA Raja was appointed as the Auditor of Castle Ltd. for the year 2019-20. Since he declined to accept the appointment, the Board of Directors appointed CA Rani as the auditor in the place of CA Raja, which was also accepted by CA Rani.

Answer

Board can appoint the auditor in the case of casual vacancy under section 139(8) of the Companies Act, 2013. The non-acceptance of appointment by CA. Raja does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant is deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of section 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been fully complied with.

Conclusion: Hence, CA. Rani is guilty of professional misconduct since she accepted the appointment without verification of statutory requirements.

Question 70

Mrs. X is a Director of ABC Pvt. Ltd. During the year 2019-20, the company appointed CA Mr. Y, Mrs. X's spouse, as its statutory auditor. Mr. Y used to deliver audit report without any comments or disclosures, thereupon.

Answer

As per Section 141(3)(f) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel. The definition of 'Relative' includes husband and wife.

Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 (now Section 139, 140 and 142 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

In this case Mrs. X is a Director of ABC Pvt. Ltd. and the company has appointed Mr. Y, Chartered Accountant, Mrs. X's spouse, as its statutory auditor. Mr. Y should not accept the appointment as statutory auditor of the company, where his wife Mrs. X is a director. This is contravention of section 141 of the Companies Act, 2013.

Conclusion: Therefore, Mr. Y is liable for misconduct under the said clause since he accepted the appointment without first verifying the compliance of statutory requirements.

Question 71

CA. X was appointed as the Auditor of ABC Ltd. for 2019-20. Since he declined to accept the appointment, the Board of Directors appointed CA. Y as the auditor in the place of CA. X, which was also accepted by CA. Y.

Answer

Compliance of Statutory Requirements Before Accepting Appointment: Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Board can appoint the auditor in the case of casual vacancy under Sections 139(8)(i) and Section 139(6) of the Companies Act, 2013. The non-acceptance of appointment by CA. X does not constitute a casual vacancy to be filled by the Board. In this case, it will be deemed that no auditor

was appointed in the AGM.

Further, as per Section 139(10) of the Companies Act, 2013 when at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The appointment of the auditor by the Board is defective in law.

Hence CA. Y is guilty of professional misconduct as per Clause (9) of the First Schedule as he accepted the appointment without verification of statutory requirements.

Question 72

Mr. P a practicing chartered accountant acting as liquidator of AB & Co. charged his professional fees on percentage of the realization of assets.

Answer

Chartered Accountant in Practice Acting as Liquidator: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, CA Regulation allow the Chartered Accountant in practice to charge the fees in respect of any professional work which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a receiver or a liquidator, and the fees may be based on a percentage of the realization or disbursement of the assets.

In the given case, Mr. P, a practicing Chartered Accountant, has acted as liquidator of AB & Co. and charged his professional fees on percentage of the realisation of assets.

Therefore, Mr. P shall not be held guilty of professional misconduct as he is allowed to charge fees on percentage of the realisation of assets being a liquidator.

Question 73

Agarwal Pvt Ltd. approached CA. Prem, a Chartered Accountant in practice, for debt recovery services. CA Prem accepted the work and insisted for fees to be based on 2% of debt recovered.

Answer

Charging of Fees based on Percentage: Clause (10) of Part I to First Schedule to the Chartered Accountants Act, 1949 prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him.

However, this restriction is not applicable where such payment is permitted by the Chartered Accountants Act, 1949. The Council of the Institute has framed Regulation 192 which exempts debt recovery services where fees may be based on a percentage of the debt recovered.

In the given case, CA. Prem has insisted for fees to be based on percentage of the debt recovered (which is exempted under Regulation 192). Hence, CA. Prem will not be held guilty for professional misconduct.

Question 74

A chartered accountant holding certificate of practice and having four articled clerks registered under him accepts appointment as a full-time lecturer in a college. Also he becomes a partner with his brother in a business. Examine his conduct in the light of Chartered Accountants Act, 1949 and the regulations thereunder.

Answer

Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949 debars a chartered accountant in practice from engaging in any business or occupation other than the profession of chartered accountancy unless permitted by the Council of the Institute so to engage. This clause, in effect, has empowered the Council of the Institute to permit chartered accountants in practice to engage in any other business or occupation considered fit and proper. Accordingly, the Council had formulated Regulations 190A and 191 to the Chartered Accountants Regulations, 1988 to provide a basis for considering applications of chartered accountants seeking permission to engage in other business or occupation. A member can accept full-time lecturer-ship in a college only after obtaining the specific and prior approval of the Council as also becoming a partner in a business with his brother would require specific permission.

Conclusion: Thus, the chartered accountant is liable for professional misconduct since he failed to obtain specific and prior approval of the Council in each case

Question 75

Mr. A, a practicing Chartered Accountant, took over as the executive chairman of Software Company on 1.4.2019. On 10.4.2019 he applied to the Council for permission.

Answer

Specific Permission to be Obtained: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

In the instant case, Mr. A took over as the executive chairman on 01.04.2019 and applied for permission on 10.04.2019. On the basis of these facts, he was engaged in other occupation between the period 01.04.2019 and 10.04.2019, without the permission of the Council.

Conclusion: Therefore, Mr. A is guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 76

C.A. Prabhu is a leading income tax practitioner and consultant for derivative products. He resides in Mumbai near to the ABC commodity stock exchange and does trading in commodity derivatives. Every day, he invests nearly 50% of his time to settle the commodity transactions. Is C.A. Prabhu liable for professional misconduct?

Answer

Engaging into a Business: As per Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949, 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 Accountant unless permitted by the Council so to engage.

However, the Council has granted general permission to the members to engage in certain

specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

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

Conclusion: Hence, specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949.

Question 77

CA. Z who is a leading Income Tax Practitioner and consultant in Jaipur is also trading in derivatives.

Answer

Engaging into Business/Profession Other Than the Profession of CA: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949 (hereinafter referred as 'Act'), a Chartered Accountant is deemed to be guilty of professional misconduct if he "engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage".

However, the Council has granted general permission to the members to engage in 12 specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

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

Hence specific permission of the Institute has to be obtained otherwise he will be deemed to be guilty of professional misconduct under Clause (11) of Part I of First Schedule of the Act.

Question 78

M, a Chartered Accountant in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2020. In January 2020, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd.

Answer

Independence of Auditor: 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 79

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

Answer

Appointment of a Chartered Accountant 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.

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 9 of Chartered Accountants Regulations, 1988, a Chartered Accountant in practice may hold the office of a Managing Director or 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.

Question 80

Mr. J.J. a practicing Chartered Accountant engages himself as part time finance manager of Quick Return Securities Ltd. He is of the view that as both functions are independent, he need not take permission from the Institute.

Answer

Engaging in any Business other than the Profession of Chartered Accountants: Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949 states that a Chartered Accountant is deemed to be guilty of professional misconduct if he engages in any business other than the profession of Chartered Accountant unless permitted by the Council for the same.

In the given case, Mr. J. J. a practicing Chartered Accountant is engaging himself as part time Finance Manager without the permission of the Institute which is misconduct attracted by Clause (11) of Part I of First Schedule.

Question 81

Mr. J started his practice as Chartered Accountant in 2019. During 2020, he got an offer for the post of Chief Accountant of a Software Development Company, as a fulltime employee, for a salary of ₹ 60,000 per month. On accepting this offer, Mr. J converted his practice into a partnership firm by taking a fresh Chartered Accountant as his partner. Mr. J neither intimated the Institute nor obtained permission from the Institute about his employment. Will Mr. J be held guilty under the Chartered Accountants Act?

Answer

Failure to take Permission before Accepting Employment: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, Mr. J will be held guilty since he has accepted the full time salaried employment in addition to the practice of Chartered Accountancy without obtaining permission of the Institute.

The Chartered Accountants Regulation, 1988 provide that a Chartered Accountant in practice shall not engage in any business or occupation other than the profession of accountancy except with the permission granted in accordance with the provisions contained in Regulation 190A. It requires member of the Institute in practice to engage in full-time or part-time employment after obtaining the specific and prior approval of the Council. Further, Mr. J will be held guilty of

professional misconduct under Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 if contravenes any of the provisions of the Act since he has failed to inform the Institute.

Question 82

CA Ram is practicing in the field of financial management planning for over 12 years. He has gained expertise in this domain over others.

Mr. Ratan, a student of Chartered Accountancy course, is very much impressed with the knowledge of CA. Ram. He approached CA. Ram to take guidance on some topics of financial management subject related to his course. CA. Ram, on request, decided to spare some time and started providing private tutorship to Mr. Ratan along with some other aspirants. However, he forgot to take specific permission for such private tutorship from the Council.

Answer

Permission for Providing Private Tutorship: As per Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Further, regulation 190A of the Chartered Accountants Regulation, 1988 provides that a Chartered Accountant in practice shall not engage in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council. According to the same there is no specific permission from the council would be necessary in the case of private tutorship.

In the given case, CA. Ram has started providing private tutorship to Mr. Ratan along with some other aspirants, without obtaining specific or prior approval of the Council.

On this context, it may be noted that the Council has provided general permission for providing such private tutorship. Therefore, CA. Ram would not be held guilty of professional misconduct under Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Question 83

CA. Moni is practicing since 2009 in the field of company audit. Due to her good practical knowledge, she was offered editorship of a 'Company Audit' Journal which she accepted. However, she did not take any permission from the Council regarding such editorship.

Answer

Permission from the Council: As per Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

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

In the instant case, CA. Moni accepted editorship of a journal for which she did not take any permission from the Council. In this context, it may be noted that the editorship of professional journals is covered under the general permission and specific permission is not required.

Therefore, CA. Moni shall not be held guilty of professional misconduct in terms of Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 84

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

Answer

Power of Signing Reports and Financial Statements: Under Clause (12) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant 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 Chartered Accountants Act, 1949 stipulates that no person other than the member of the institute shall sign any document on behalf of a Chartered Accountant in practice or a firm of Chartered Accountants 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.

Further, Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

Conclusion: Accordingly, S is guilty of professional misconduct under Clause (12) of Part I of First Schedule and also under Clause (1) of Part II of Second Schedule for contravening Section 26.

Question 85

CA. Smart, a practicing Chartered Accountant was on Europe tour between 15-9-16 and 25-9-16. On 18-9-16 a message was received from one of his clients requesting for a stock certificate to be produced to the bank on or before 20-9-16. Due to urgency, CA. Smart directed his assistant, who is also a Chartered Accountant, to sign and issue the stock certificate after due verification, on his behalf.

Answer

Allowing a Member Not Being a Partner to Sign Certificate: As per Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant 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".

In this case, CA. Smart allowed his assistant who is not a partner but a member of the Institute of Chartered Accountants of India to sign stock certificate on his behalf and thereby commits misconduct.

Conclusion: Thus, CA. Smart is guilty of professional misconduct under Clause (12) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 86

Mr. 'A' is a practicing Chartered Accountant working as proprietor of M/s A & Co. He went abroad for 3 months. He delegated the authority to Mr. 'Y' a Chartered Accountant his employee for taking care of routine matters of his office. During his absence Mr. 'Y' has conducted the under mentioned jobs in the name of M/s A & Co.

- (i) He issued the audit queries to client which were raised during the course of audit.
- (ii) He issued production certificate to a client under Central Excise Act, 1944.
- (iii) He attended the Income Tax proceedings for a client as authorized representative before Income Tax Authorities.

Please comment on eligibility of Mr. 'Y' for conducting such jobs in name of M/s A & Co. and liability of Mr. 'A' under the Chartered Accountants Act, 1949.

Answer

Delegation of Authority to the Employee: As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant 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".

In this case CA. 'A' proprietor of M/s A & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, at tending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

- (i) In the given case, Mr. 'Y', a chartered accountant being employee of M/s A & Co. has issued audit queries which were raised during the course of audit. Here "Y" is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.
- (ii) Further, issuance of production certificate to a client under Central Excise Act, 1944 by Mr. "Y" being an employee of M/s A & Co. (an audit firm), is not a routine work and it is outside his authorities. Thus, CA. 'A' is guilty of professional misconduct under Clause (12) of Part I of First Schedule of the Chartered Accountants Act, 1949.
- (iii) In this instance, Mr. "Y", CA employee of the audit firm M/s A & Co. has attended the Income tax proceedings for a client as authorized representative before Income Tax Authorities. Since the council has allowed the delegation of such work, the chartered accountant employee can attend to routine matter in tax practice as decided by the council, subject to provisions of Section 288 of the Income Tax Act. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

Question 87

Mr. 'K', a practicing Chartered Accountant is the proprietor of M/s K & Co. since 1995. He went abroad in the month of December 2019. He delegated the authority to Mr. 'Y' a Chartered Accountant, his employee for taking care of the important matters of his office. During his absence

Mr. 'Y' has conducted the undermentioned jobs in the name of M/s K & Co.

- (i) He issued Net worth certificate to a client for furnishing to a Bank.
- (ii) He attended the GST proceedings for a client as authorized representative before GST Authorities.

Please comment on eligibility of Mr. 'Y' for conducting such jobs in name of M/s K & Co. and liability of Mr. 'K' under the Chartered Accountants Act, 1949. .

Answer

Delegation of Authority to the Employee: As per **Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949**, a Chartered Accountant 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".

In this case CA. 'K' proprietor of M/s K & Co., went abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of the important matters of his office who is not a partner but a member of the Institute of Chartered Accountants of India.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, attending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

- (i) In the given case, Mr. 'Y', a chartered accountant being employee of M/s K & Co. has **issued net worth certificate for furnishing to a bank**. Since the issuance of net worth certificate to a client by Mr. "Y" being an employee of M/s K& Co. (an audit firm), is **not a routine work and it is outside his authorities**. Thus, **CA. 'K' is guilty of professional misconduct** under Clause (12) of Part I of First Schedule of the Chartered Accountants Act, 1949.
- (ii) Further, Mr. "Y", CA employee of the audit firm M/s K& Co. has **attended the GST proceedings** for a client as authorized representative before GST Authorities. Since the **council has allowed the delegation of such work**, the chartered accountant employee can attend to routine matter in tax practice as decided by the council. Therefore, there is **no misconduct in this case** as per Clause (12) of Part I of First schedule to the Act.

Question 88

Mr. S, the auditor of ABC Pvt. Ltd. has delegated following works to his articles and staff:

- i. Issue of audit queries during the course of audit.
- ii. Issue of memorandum of cash verification and other physical verification.
- iii. Letter forwarding draft observations/financial statements.
- iv. Issuing acknowledgements for records produced.
- v. Signing financial statements of the company.

Is this correct as per the Professional Ethics and ICAI's guidelines and pronouncements?

Answer

As per Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant 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.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated in the following instances and such delegation will not attract provisions of this clause:

- (i) Issue of audit queries during the course of audit.
- (ii) Asking for information or issue of questionnaire.
- (iii) Letter forwarding draft observations/financial statements.
- (iv) Initiating and stamping of vouchers and of schedules prepared for the purpose of audit.
- (v) Acknowledging and carrying on routine correspondence with clients.
- (vi) Issue of memorandum of cash verification and other physical verification or recording the results thereof in the books of the clients.
- (vii) Issuing acknowledgements for records produced. Raising of bills and issuing acknowledgements for money receipts.
- (viii) Attending to routine matters in tax practice, subject to provisions of Section 288 of Income Tax Act.
- (ix) Any other matter incidental to the office administration and routine work involved in practice of accountancy.

In the instant case, Mr. S, the auditor of ABC Pvt. Ltd. has delegated certain task to his articles and staff such as issue of audit queries during the course of audit, issue of memorandum of cash verification and other physical verification, letter forwarding draft observations/financial statements, issuing acknowledgements for records produced and signing financial statements of the company.

Therefore, Mr. S is correct in allowing first four tasks i.e. issue of audit queries during the course of audit, issue of memorandum of cash verification and other physical verification, letter forwarding draft observations/financial statements, issuing acknowledgements for records produced to his staff and articles.

However, if the person signing the financial statements on his behalf is not 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, Mr. S is wrong in delegating signing of financial statements to his staff.

Conclusion: In view of this, S would be guilty of professional misconduct for allowing the person signing the financial statements on his behalf to his articles and staff under Clause 12 of Part 1 of First Schedule of the Chartered Accountants Act, 1949.

Question 89

Mr. 'C', a Chartered Accountant holds a certificate of practice while in employment also, recommends a particular lawyer to his employer in respect of a case. The lawyer, out of the

professional fee received from employer paid a particular sum as referral fee to Mr. 'C'.

Answer

Referral Fee from Lawyer: According to Clause (2) of Part II of First Schedule of the Chartered Accountant Act, 1949, a member of the Institute (other than a member in practice) shall be guilty of professional misconduct, if he being an employee of any company, firm or person accepts or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

In the present case, Mr. C who besides holding a certificate of practice, is also an employee and by referring a lawyer to the company in respect of a case, he receives a particular sum as referral fee from the lawyer out of his professional fee.

Conclusion: Therefore, Mr. C is guilty of professional misconduct by virtue of Clause (2) of Part II of First schedule.

Question 90

Mr. 'G', while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business.

Answer

Disclosure of Information: As per Clause (2) of Part III of First Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty if a Chartered Accountant, in practice or not, does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority;

In the given case, Mr. "G", a Chartered Accountant while applying for a certificate of practice, did not fill in the columns which solicit information about his engagement in other occupation or business, while he was indeed engaged in a business. Details of engagement in business need to be disclosed while applying for the certificate of practice as it was the information called for in the application, by the Institute.

Conclusion: Thus, Mr. G will be held guilty for professional misconduct under the Clause (2) of Part III of First Schedule of the Chartered Accountants Act, 1949.

Question 91

Mr. X, a Chartered Accountant, employed as a paid Assistant with a Chartered Accountant firm. On 31st December, 2019 he leaves the services of the firm. Despite many reminders from ICAI he fails to reply regarding the date of leaving the services of the firm.

Answer

Failed to Supply Information Called For: As per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate

authority.

Conclusion: Thus, in the given case, Mr. X has failed to reply to the letters of the Institute asking him to confirm the date of leaving the service as a paid assistant. Therefore, he is held guilty of professional misconduct as per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

Question 92

A chartered accountant in practice, in spite of repeated requests from the Secretary of the Institute fails to submit form 18. Is he liable for misconduct?

Answer

Clause (2) of Part III of the First Schedule requires a member to supply the information called for by the Council or any of its Committees and Clause (1) of Part II of the Second Schedule requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulation made thereunder. Under the former clause, it is misconduct for chartered accountants generally, if they do not supply the information called for by the Council. The Secretary acts for the Council; hence, request from the Secretary amounts to a request from the Council. Besides, it is also a contravention of Regulation of the Chartered Accountants Regulations, 1988. Thus, failure to submit Form 18 (deals with Deed of Assignment of Articles where the Articled Clerk is a minor) constitutes professional misconduct.

Question 93

XYZ Associates, a Chartered Accountants Firm is having a relationship with a multi-national accounting firm in India. The ICAI required that all firms having networking relationship with any other entity need to furnish information online within the stipulated time. XYZ Associates failed to respond. Comment on this with reference to Professional misconduct, if any.

Answer

Failed to Supply Information Called For: As per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, will be deemed to be guilty of professional misconduct if he does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate authority.

Thus, in the given case, Mr. XYZ Associates, a chartered accountant firm is failed to furnish the information of its relationship with multi-national accounting firm in India. The ICAI required this information to be submitted online within the stipulated time. XYZ Associates failed to respond and submit the required information. Therefore, XYZ Associates is held guilty of professional misconduct as per Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.

Question 94

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

Answer

This is a case which is covered under the expression in other misconduct of the Chartered Accountants Act, 1949. As per Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949, 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. Here the Chartered Accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, YKS & Co, being a concurrent auditor used his position to obtain the funds and failed to repay the same to the bank. This brings disrepute to the profession of a Chartered Accountant. This act of YKS & Co is not pardonable.

Conclusion: Therefore, YKS & Co will be held guilty of other misconduct under Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949.

Question 95

Mr. R, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of ₹ 25 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and staff will be filed without charging any fees, as quid Pro quo for the loan sanctioned.

Answer

Bringing Disrepute to the Profession: Clause (2) of Part IV of First Schedule to the Chartered Accountants Act, 1949 states that member of the Institute, whether in practice or not, shall be deemed guilty of other misconduct, if he in the opinion of the Council, brings disrepute to the profession or to the Institute as a result of his action whether or not related to his professional work".

Accordingly, a Chartered Accountant is also expected to maintain the highest standards and integrity even in his personal affairs and any deviation from these standards calls for disciplinary action.

In the present case, the action of Mr. R, a Chartered Accountant in practice offering free service in return to sanction of loan brings disrepute to the profession of a Chartered Accountant.

Hence, Mr. R will be held guilty of other misconduct under Clause (2) of Part IV of the First Schedule to the Chartered Accountants Act, 1949.

Question 96

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".

Answer

Bringing Disrepute to the Profession: 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 Clause (2) of Part IV of the First Schedule to the Chartered Accountants Act, 1949, 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”.

Question 97

Ms. Preeto, a CA, had an account with a bank. The normal balance in this account remained at a level below ₹ 5,000. The bank inadvertently credited this account with a cheque of ₹ 2,70,000 belonging to another account holder. When CA. Preeto came to know about this she withdrew the amount of ₹ 2,75,000 and closed the bank account. After 1 year the bank noticed the mistake and claimed ₹ 2,75,000 with interest. CA. Preeto contested this claim. Can the bank approach the Institute of Chartered Accountants of India for disciplinary action against CA. Preeto?

Answer

Disrepute to the Profession: As per Clause 2 of Part IV of First Schedule of the Chartered Accountant Act, 1949, a Chartered Accountant will 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.

In the instant case, CA. Preeto, a CA, had an account with a bank from which she withdrew the amount of ₹2,75,000 and closed the account. This amount of ₹2,75,000 was pertaining to ₹ 5,000 minimum balance and ₹ 2,70,000 belonging to other account holder and inadvertently credited to his account by the bank. The said act of CA. Preeto to withdraw the money which does not belongs to her will bring disrepute to the profession. Hence under this clause the bank can file a suitable complaint under Clause 2 of Part IV of First Schedule of the Chartered Accountant Act, 1949 with the Institute of Chartered Accountants of India.

Second Schedule

Question 98

Mr. Parekh, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Leather Industry. During the course of his presentation he shared some of the vital information of his client's business under the impression that it will help the Nation to compete with other countries at international level.

Answer

Disclosure of Client's Information: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 deals with the professional misconduct relating to the disclosure of information by a chartered accountant in practice relating to the business of his clients to any person other than his client without the consent of his client or otherwise than as required by any law for the time being in force would amount to breach of conduct. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties. In the given case, Mr. Parekh has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level. Thus it is a professional misconduct covered by Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Question 99

XYZ Co. Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices that you are the auditor and requests you to call at the bank for a discussion. In the course of discussions, the bank asks for your opinion regarding the company and also asks for detailed information regarding a few items in the financial statements. The information is available in your working paper file. What should be your response and why?

Answer

Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force. SA 200 on " Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". In the instant case, the bank has asked the auditor for detailed information regarding few items in the financial statements available in his working papers. Having regard to the position stated earlier, the auditor cannot disclose the information in his possession without specific permission of the client. As far as working papers are concerned, working papers are the property of the auditor. The auditor may at his discretion, make portions of or extracts from his working papers available to his client". Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

Question 100

Mr. B, a Chartered Accountant in practice was invited to deliver a seminar on GST which was attended by professionals as well as by representatives of various Industries. One section of audience raised a particular issue unique to the industry to which it pertains. Mr. B enthusiastically explained the issue and elaborated how he actually solved this, for his client facing the same issue with worked out examples from the computer storage device using the actual data of one of his clients with full identification of client details being displayed to the group for the sake giving clarity on a topic in a real life situation. Comment his acts in the light of Code of Conduct.

Answer

Disclosure of Information to third Party: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force.

SA 200 on " Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of information acquired during his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose".

In the instant case, Mr. B is a Chartered Accountant in practice and he was invited to deliver a seminar on GST which was attended by professional as well as by representatives of various industries. During his session, a query was raised on particular issue and Mr. B used the actual data of one of his clients with full identification of client details displayed to explain and elaborate such query. Applying the above provision, the auditor cannot disclose the information in his possession without specific permission of the client. Thus, CA. B will be liable for professional misconduct under clause 1 of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Question 101

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

Answer

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

Mr. Mohan has issued a certificate of consumption which does not reflect the correct factual position of the consumption of raw material by the concerned entity. He has failed in his duty of examining the record. He has relied on the minutes of Board of director's meeting which is not proper evidence to show the consumption of raw material. The relevant record of production and stock register should have been scrutinized thoroughly and properly.

Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949 also applies to this

case which states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

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

Question 102

Z, a Chartered Accountant, certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client.

Answer

Certification of Financial Forecast: Under Clause (3) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant 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.

Further, SAE 3400 "The Examination of Prospective Financial Information", provides that the management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the sources of information, the basis of forecasts and the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes. Thus, while making report on projection, the auditor need to mention that his responsibility is to examine the evidence supporting the assumptions and other information in the prospective financial information, his responsibility does not include verification of the accuracy of the projections, therefore, he does not vouch for the accuracy of the same.

In the instant case, Mr. Z has certified a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client. Thus, Mr. Z will not be held guilty of misconduct if all the requirements have been complied with or vice versa.

Question 103

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.

Answer

Certification of Financial Forecast: 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.

Further, SAE 3400 "The Examination of Prospective Financial Information", provides that the management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the sources of information, the basis of forecasts and the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes. Thus, while making report on projection, the auditor need to mention that his responsibility is to examine the evidence supporting the assumptions and other information in the prospective financial information, his responsibility does not include verification of the accuracy of the projections, therefore, he does not vouch for the accuracy of

the same.

Hence, the offer can be accepted if the above requirements are complied with.

Question 104

A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company.

Answer

Evaluation of Cost of Products: Clause (4) of Part I of the Second Schedule to Chartered Accountants Act, 1949, states that expressing an opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest would constitute misconduct. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements. As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and moreover its partner was on the Board. Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.

Question 105

Mr. Shah, a Chartered Accountant certified the financial statements of a company in which his wife is a Director holding substantial interest.

Answer

Relative of Auditor Holding Position of Director with Substantial Interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business or enterprise in which he, his firm or partner in his firm has a substantial interest, he is committing professional misconduct. Further as per Council General Guidelines, 2008, a member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons, who are his “relatives” within the meaning of AS 18 have, either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise.

The Council also emphasizes that the aforesaid requirement of Clause (4) is equally applicable while performing all types of attest functions by the members.

This is further a contravention of section 141(3)(f) of the Companies Act, 2013, which requires that a person shall not be eligible for appointment as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

In the given case, Mr. Shah, Chartered Accountant, has certified the financial statements of a company in which his wife is a director with substantial interest. Hence, this amounts to professional misconduct which attracts Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 and Mr. Shah shall have to vacate the office accordingly.

Question 106

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

Answer

Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949 prohibits a member to engage in any business or occupation other than the profession of chartered accountants unless permitted by the Council so to engage. It does not prohibit a Chartered Accountant from being a director of a company, except managing director or a whole time director. But if any of the partners is interested in such company as an auditor then he cannot be director of the said company.

In the present case Mr. B has accepted the directorship in a Company, where his partner Mr. C is an auditor, without obtaining specific permission of the council. Hence, Mr. B will be held guilty for professional misconduct under Clause (11) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Further, the Council of the Institute of Chartered Accountants of India has categorically stated that in cases where a member is a director of a company, the firm, in which the said member is a partner, should not express any opinion on its financial statements. Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that expressing an opinion on financial statements of any business or enterprise in which he, his firm or a partner of his firm has a substantial interest would constitute misconduct.

Additionally, Section 141(3)(c) of the Companies Act, 2013 also disqualifies a person to be appointed as an auditor if he is a partner of an officer of the company. Furthermore, section 141(4) of the Companies Act, 2013 requires the appointed auditor to vacate his office if he incurs any of the disqualifications mentioned under sub-section (3).

Therefore, in cases, where a member of the Institute is a director of a company, or the firm, in which said member is a partner, should not express any opinion on its financial statements. Hence Mr. C, a partner of Mr. B, should vacate the office.

Question 107

Mr. A has been appointed statutory auditor of a private limited company where his spouse's sister's husband is having 75% ownership.

Answer

Appointment of Auditor in case of Relative Holding Substantial Interest: Clause (4) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if an auditor expresses his opinion on the financial statements of any business or enterprises in which he, his firm or a partner in his firm has a substantial interest, he is committing professional misconduct.

Further as per Council General Guidelines, a member of the Institute shall not express his opinion on financial statements of any business or enterprise in which one or more persons, who are his "relatives" within the meaning of AS 18 have, either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise. It may be noted that the spouses' sisters' husband does not fall within this definition.

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

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

Question 108

Mr. D, a practicing CA, is appointed as a Director Simplicitor in XYZ Pvt. Ltd. After one year of appointment, Mr. D resigned as the Director and accepted the Statutory Auditor position of the company. Is Mr. D right in accepting the auditor position?

Answer

As per Clause (4) of Part I of the Second Schedule of the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.

Section 141 of the Companies Act, 2013 specifically prohibits a member from auditing the accounts of a company in which he is an officer or employee. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally applicable in those situations also. Therefore, the Council's views are clarified in the following situations.

As per the clarifications issued by the Council, a member shall not accept the assignment of audit of a Company for a period of two years from the date of completion of his tenure as Director, or resignation as Director of the said Company.

In the instant case, Mr. D, a practicing CA, is appointed as a Director Simplicitor in XYZ Pvt. Ltd. After one year of appointment, Mr. D resigned as the Director and accepted the Statutory Auditor position of the company. In view of above provisions Mr. D cannot accept the Directorship of the company until the completion of two years after his resignation.

Thus, CA, D would be held guilty of professional misconduct under clause 4 of Part 1 of Second Schedule of the Chartered Accountants Act, 1949.

Question 109

Mr. Joe, a Chartered Accountant during the course of audit of M/s XYZ Ltd. came to know that the company has taken a loan of ₹ 10 lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in his report.

Answer

Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading. In this case, Mr. Joe has come across information that a loan of ₹ 10 lakhs has been taken by the company from Employees Provident Fund. This is contravention of Rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements. The very fact that Mr. Joe has failed to disclose this fact in his report, he is attracted by

the provisions of professional misconduct under Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Question 110

A practicing Chartered Accountant was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain information and explanations to the authorities, which were found to be false and misleading.

Answer

Submitting Information as Authorised Representative: As per Clause (5) of Part I of Second Schedule to the Chartered Accountant Act, 1949, if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under Clause (5). As per Clause (6) of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under Clause (6).

In given case, the Chartered Accountant had submitted the statements before the taxation authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence the Chartered Accountant would not be held liable for professional misconduct.

Question 111

The superannuation-cum-pension fund for the employees of a company was under a separate 'trust'. Both the company and the trust were under the same management. The auditor, who was auditing the accounts of the company as well as the trust noted some irregularities in the operation of the trust and commented upon these irregularities in the confidential report given to the trustees, but did not mention about these irregularities in his report on the Annual accounts of the Trust.

Answer

Disclosure of Material Facts: A Chartered Accountant in practice is deemed to be guilty of professional misconduct under Clause (5) of Part I of the Second Schedule if he "fails to disclose a material fact known to him which is not disclosed in a financial statement but disclosure of which is necessary to make the financial statement not misleading". In this case, the Chartered Accountant was aware of the contraventions and irregularities committed by the trust as these were referred to in the confidential report given by the Chartered Accountant to the trustees of the company. However, he had issued the annual accounts without any qualification. On similar facts it was held by the Supreme Court in *Kishori Lal Dutta vs. P. K. Mukherjee* that it was the duty of the Chartered Accountant to have disclosed the irregularities and contravention to the beneficiaries of the fund in the statement of accounts signed by him. Accordingly, in the present case also it has to be held that the Chartered Accountant is guilty of professional misconduct if the amount of irregularities is proved material.

Question 112

Loans were given out of the funds of an Employees Provident Fund to the employer company in contravention of the applicable rules. As the auditor of the said Provident Fund, M discloses the contraventions to the Trustees of the fund, but failed to do so to the members of the fund. Comment.

Answer

Failed to Report Material Misstatement: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under Clause (5).

Further, as per Clause (6) of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under Clause (6).

In the given Case, CA M has contravened Clause (5) of Part I of Second Schedule as it is the duty of a CA in practice to disclose material facts known to him so that the financial statement does not become misleading.

Further the auditor CA should disclose such facts to beneficiaries of a fund in applicable cases. Technically, appointment of an auditor could be done by a company through its directors, but in substance the auditor in such cases addresses to the beneficiaries just like he gives his report to the shareholders of a company.

Therefore, in the instant case Mr. M is found guilty of professional misconduct.

Question 113

Mr. J, a Chartered Accountant has identified that ABC Ltd. has taken a loan of ₹ 15 lakhs from Provident Fund Account, during the course of audit. The said loan was not reflected in the books of accounts and statements were prepared ignoring the same.

Answer

Failure to Disclose Material Facts: As per Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a chartered Accountant in practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading.

In the present case, Mr. J has come across information that a loan of ₹ 15 lakhs has been taken by the company from Provident Fund. This is contravention of rules and the said loan has not been reflected in the books of accounts. Further, this material fact has also to be disclosed in the financial statements.

Mr. J has failed to disclose this fact in his report. Therefore, he is attracted by the provisions of professional misconduct under Clause (5) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Question 114

D, a Chartered Accountant in practice was appointed by Realty Limited to represent its cases before

GST Authorities under a duly executed power of representation. In the course of proceedings he submitted certain statements-written as well as oral-which later found to be false and materially misleading. Comment this in the light of Professional Code.

Answer

Submitting Information as Authorized Representative: As per Clause (5) of Part I of Second Schedule to the Chartered Accountant Act, 1949, if a member in practice fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading, where he is concerned with that financial statement in a professional capacity, he will be held guilty under Clause (5). As per Clause (6) of Part I of Second Schedule if he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity, he will be held guilty under Clause (6).

In given case, the Chartered Accountant had submitted the statements before the GST authorities. These statements are based on the data provided by the management of the company. Although the statements prepared were based on incorrect facts and misleading, the Chartered Accountant had only submitted them acting on the instructions of his client as his authorized representative.

Hence Mr. D would not be held liable for professional misconduct.

Question 115

The Cashier of a company committed a fraud and absconded with the proceeds thereof. This happened during the course of the accounting year. The Chief Accountant of the company also did not know about fraud.

In the course of the audit, at the end of the year, the auditor failed to discover the fraud. After the audit was completed, however, the fraud was discovered by the Chief Accountant. Investigation made at that time indicates that the auditor did not exercise proper skill and care and performed his work in a desultory and haphazard manner. With this background, the Directors of the company intend to file disciplinary proceedings against the auditor.

Discuss the position of the auditor with regard to the disciplinary proceedings.

Answer

Failure to Exercise Reasonable Care and Skill: Apparently, as it appears from the facts of the case that the auditor did not exercise proper skill and care and that he performed his work in a desultory and haphazard manner. In this matter, the test for auditor's liability lies in whether he has applied reasonable care, skill and caution called for in the circumstances of the case and whether he reasonably used all the information that he came across in the course of audit. Cash is a very significant item in any situation and the fact that the cashier had left during the year without notice should have placed the auditor on alert as regards the cash book. In fact, the very fact that the cashier was absconding, i.e., left without any notice constituted sufficient circumstances to excite suspicion of the auditor to probe to the bottom. As per SA 240, "The auditor's responsibilities relating to fraud in an audit of financial statements", it can be concluded that the auditor did not plan and perform the audit with an attitude of professional skepticism. Thus, having regard to this and a fraud has actually taken place during the year, committed by the absconding cashier, it is reasonable to think that prima facie there is a case against the auditor for gross negligence. Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties. As it appears from the facts of the case, the auditor has been

grossly negligent in performing his duties which constitutes professional misconduct. Thus, such instances require reference to Disciplinary Committee of the Council of the Institute. If a member is found guilty by the Council of any of the acts or omissions stated in the Schedule, its finding with recommendations are to be referred to the High Court for decision.

Question 116

CA. ZZ who conducted ABC audit of a marathi daily 'New Era' certified the circulation figures based on Management Information System Report (M.I.S Report) without examining the books of Account.

Answer

Certification without Examining Books of Account: According to Clause (7) of Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he "does not exercise due diligence or is grossly negligent in the conduct of his professional duties".

In the instant case, CA. ZZ did not exercise due diligence and is grossly negligent in the conduct of his professional duties since he certified the circulation figures without examining the books of accounts.

To ascertain the number of paid copies verification of remittances from the agents, credit allowed to the agents for unsold copies returned, examination of books of account is essential.

Further certification of circulation figures based on statistical information without cross verification with financial records amounts to gross negligence and failure to exercise due diligence.

Hence, CA. ZZ is guilty of professional misconduct as per Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949.

Question 117

Mr. D, a practicing Chartered Accountant, did not complete his work relating to the audit of the accounts of a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirements.

Answer

Not Exercising Due Diligence: According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with statutory requirement in this regard. He was guilty of professional misconduct under Clause (7).

Since Mr. D has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements, therefore, the auditor is guilty of professional misconduct under Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Question 118

Mr. Brainy, a Chartered Accountant in practice, is the auditor of Fair Ltd. He advised the Managing Director of the company to include 'orders under negotiation' in sales, to reflect higher profit and better financial position for obtaining bank loans in future. Mr. Brainy, thereafter, gave clean reports on the balance sheet prepared accordingly without examining the accounts.

Answer

Grossly Negligent and Bringing Disrepute to the Institute: Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he does not exercise due diligence, or is grossly negligent in the conduct of his professional duties.

Furthermore, Clause (2) of Part IV of the First Schedule to the said Act states that 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.

In the given case, Mr. Brainy, a Chartered Accountant in practice, is grossly negligence in conduct of his professional duties by issuing clean reports on the balance sheet without examining the accounts. Further, he has also brought disrepute to the profession by advising unethical practice to the managing director of the company. Therefore, Mr. Brainy will be held guilty for professional and other misconduct under abovementioned Clauses to the Chartered Accountants Act, 1949.

Question 119

Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

Answer

Failure to Obtain Information: Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct.

In the instant case Mr. Z, a practicing Chartered Accountant issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e, by not looking into the financial records, bank statements or bank pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for.

The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. Z ought to have verified the basic records to ensure the correctness of circulation figures.

Thus, in the present case Mr. Z will be held guilty of professional misconduct as per Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Alternative Solution is possible on the basis of Clause (7) of Part I of Second Schedule to the

Chartered Accountants Act, 1949.

Question 120

Mr. A, a Chartered Accountant was the auditor of 'A Limited'. During the financial year 2015-16, the investment appeared in the Balance Sheet of the company of ₹ 10 lakhs and was the same amount as in the last year. Later on, it was found that the company's investments were only ₹ 25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan.

Answer

Grossly Negligent in Conduct of Duties: As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Accordingly, Mr. A, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

Question 121

Mr. Jain, a Chartered Accountant certified the circulation of "Good Luck" a weekly magazine without examination of financial records and other required documents.

Answer

Failure to Obtain Information: Clause (8) of Part I of Second Schedule to Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct. Mr. Jain, a Chartered Accountant, certified the circulation figures of Good Luck, a weekly magazine without examination of financial records and other required documents. The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. Jain ought to have verified the basic records such as print order, printer's bill, number of copies sold and paid for, number of copies returned unsold to ensure the correctness of circulation figures. Thus in the present case, Mr. Jain will be held guilty of professional misconduct.

Question 122

Mr. K, a Chartered Accountant certified the circulation of a weekly magazine without examining the records and relevant documents.

Answer

Failure to Obtain Information: Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that if a Chartered Accountant in practice fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficient material to negate the expression of an opinion, the chartered accountant shall be deemed to be guilty of a professional misconduct.

Mr. K, a Chartered Accountant, certified the circulation of a weekly magazine without examination of records and other relevant documents. The chartered accountant should not express his opinion before obtaining the required data and information. As an auditor, Mr. K ought to have verified the basic records such as print order, printer's bill, number of copies sold and paid for, number of copies returned unsold to ensure the correctness of circulation figures.

Thus, in the present case, Mr. K will be held guilty of professional misconduct under Clause (8) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Question 123

A charitable institution entrusted ₹ 10 lakhs with its auditors M/s Ram and Co., a Chartered Accountant firm, to invest in a specified securities. The auditors pending investment of the money, deposited it in their Savings bank account and no investment was made in the next three months.

Answer

Failure to Keep Money in Separate Bank Account: If a Chartered Accountant in practice fails to keep moneys of his clients in a separate bank account or fails to use such moneys for purposes for which they are intended then his action would amount to professional misconduct under Clause (10) of Part I of Second Schedule to the Chartered Accountants Act, 1949. In the course of his engagement as a professional accountant, a member may be entrusted with moneys belonging to his client. If he should receive such funds, it would be his duty to deposit them in a separate banking account, and to utilise such funds only in accordance with the instructions of the client or for the purposes intended by the client. In the given case by depositing the client's money by M/s Ram and Co., a firm of Chartered Accountants, in their own savings bank account, the auditors have committed a professional misconduct. Hence in the given case, M/s Ram & Co. will be held guilty of professional misconduct.

Question 124

M/s XYZ a firm of Chartered Accountants received ₹ 2 lakhs in January, 2020 on behalf of one of their clients, who has gone abroad and deposited the amount in their Bank account, so that they can return the money to the client in July, 2020, when he is due to return to India.

Answer

Money of Clients to be Deposited in Separate Bank Account: Clause (10) of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if "he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended".

XYZ received the money in January, 2020 which is to be paid only in July 2020; hence it should be deposited in a separate bank account. Since in this case XYZ have failed to keep the sum of ₹ 2 lakhs received on behalf of their client in a separate Bank Account it amounts to professional misconduct under Clause (10) of Part I of Second Schedule.

Question 125

Mr. Z, a practicing Chartered Accountant, received a sum of ₹ 1 lac on 1.9.2019 from a Client who intends to leave abroad for a period of a year, with a request that his advance tax liabilities to be paid over the three instalments on 15th September, 2019, 15th December, 2019 and 15th March, 2020. After remitting the 1st instalment of advance tax on 15.9.2019, Z did not keep the Balance Money in a separate Bank account and he is of the opinion he will remit the money within reasonable time as per payment schedule of Advance tax.

Answer

Money of Client to be Kept in Separate Bank Account: As per Clause (10) of Part I of Second Schedule to the Chartered Accountant Act, 1949, a Chartered Accountant in practice will be deemed to be guilty of professional misconduct if he fails to keep moneys of his client other than the fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

The term reasonable time would depend upon the circumstances of the case. Moneys which are intended to be spent within a reasonably short time need not be put in a separate bank account.

Thus, in the instant case, Mr. Z should have kept the balance money after remitting the first instalment of advance tax into a separate bank account. Hence, he is guilty of professional misconduct as per Clause (10) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

Question 126

M/s. ABC, a firm of Chartered Accountants received ₹ 2 lakhs in March, 2020 from a client to pay the Advance Tax. However, the firm has used that money for its own purpose and later on adjusted the same with the outstanding fee payable. Comment.

Answer

Money of clients to be deposited in separate bank account: Clause (10) of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if "he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended".

M/s. ABC received the money in March, 2020 for payment of the advance tax; hence it should be deposited in a separate bank account. Since in this case M/s. ABC have failed to keep the sum of ₹ 2 lakhs received on behalf of their client in a separate Bank Account, it amounts to professional misconduct under Clause (10) of Part I of Second Schedule.

Question 127

Mr. Ram, a Chartered Accountant in practice, received ₹ 15,00,000 on 15th December, 2019 on behalf of one of his clients, who has gone to USA. Mr. Ram deposited the said amount in his saving

bank account (SB Account). As per instruction of the client, the said amount is to be returned to the client on March 31, 2020 when he will return to India. On the occasion of birthday of his wife Sita, Mr. Ram withdrew ₹ 5,00,000 and spent on Birthday party. He re-deposited ₹ 5,00,000 in the said SB account on 25th March, 2020 and then returned the entire amount of ₹ 15,00,000 to the client on March 31, 2020.

Answer

Clause (10) of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if “he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended.”

Mr. Ram received the money on 15th December, 2019 which is to be paid to the client only on March 31, 2020. Hence, it should be deposited in a separate bank account.

Since in this case Mr. Ram have failed to keep the sum of ₹ 15 lakhs in a separate Bank Account and utilised the part money for personal purpose on birthday occasion. Therefore, it amounts to professional misconduct under Clause (10) of Part I of Second Schedule.

Question 128

A film artist who was going abroad for long shooting, deposited a sum of ₹ 20 lakhs with his tax consultant Mr. G, a practising Chartered Accountant for payment of Goods and Service Tax monthly when they were due, Mr. G duly remitted all but one instalments. He utilised the amount of instalment which he did not pay, to remit his own advance income tax. However, while filing return of GST of the film artist, he duly remitted on her behalf the tax payable with interest due for late payment of GST out of money lying with him. He also bore for himself the interest due to short fall in remittance of tax of his client. Comment on the above in the light of Code of Conduct.

Answer

Money of Clients to be Deposited in Separate Bank Account: Clause (10) of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if “he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended”.

In the instant case, CA. G received sum of rupees 20 lakh from his client who is a film artist for monthly installment payment of Goods and Service Tax. This money should have been deposited in a separate bank account. CA. G utilized the amount of last installment for his own advance tax payment, though he paid the same along with interest and bore the interest due to short fall in remittance of tax of his client.

As per fact of the case CA. G has failed to keep the sum of rupees 20 lakh received on behalf of his client in a separate Bank Account and utilized the same for his own advance tax payment amounts to professional misconduct under Clause (10) of Part I of Second Schedule.

Question 129

M/s. ABC, a firm of Chartered Accountants has taken a loan for acquiring computers, from a company whose Managing Directors’ son is an Articled Trainee with A, a partner of M/s ABC.

Answer

Loan from a Company: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct

if he contravenes any of the provisions of Chartered Accountants Act, 1949 or Regulations made thereunder. Regulation 47 of the Chartered Accountant's Regulations, 1988, prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly. However, M/s ABC has taken loan from a company whose Managing Director happens to be father of articled clerk with Mr. A, a partner of M/s ABC. In this case, the articled trainee has no direct interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, Mr. A of M/s ABC would be held liable for professional misconduct. Thus, M/s ABC would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

Question 130

A Chartered Accountant in practice had confirmed in the application made by his articled clerk to the Council for permission to study that the normal working hours of his office were 11 a.m. to 6 p.m. and the hours during which the articled clerk was required to attend college classes were 7 a.m. to 9.30 a.m. On inquiry from Principal of College, it was ascertained that the articled clerk used to attend classes from 10 a.m. to 1.55 p.m. The Chartered Accountant pleaded ignorance about the articled clerk attending the college classes during office hours. Will the Chartered Accountant be held guilty of professional misconduct?

Answer

Failure to Observe the Regulations: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member shall be held guilty of professional misconduct if he contravenes any provision of the Act or the regulations made thereunder. The chartered accountant, as per Regulations also, is expected to impart proper practical training. In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted particularly in view of the fact that the chartered accountant did not obtain certificate from the Principal to confirm the timings. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office. Under the circumstances, the Chartered Accountant is guilty of professional misconduct in regard to the discharge of his professional duties.

Question 131

X, a practicing Chartered Accountant in an application for permission to study submitted by his Articled Assistant to the council had confirmed that the normal working hours of his office were from 11 A.M. to 6 P.M. and the hours during which the Articled Assistant was required to attend classes were 7.00 A.M. to 9.30 A.M. According to the information from College, the Articled Assistant attended the College from 10 A.M. to 1.55 P.M. on all week days. About the Articled Assistant attending the classes even during office hours, X pleaded ignorance.

Answer

Failure to Observe the Regulations: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 a member shall be held guilty of professional misconduct if he contravenes any of the provisions of the Act or the regulations made thereunder or any guidelines issued by the Council.

The chartered accountant, as per Regulations also, is expected to impart proper practical training. There is a specific circular issued which guides on timing for training for articleship.

In the instant case, the articled clerk must have not been attending office on a regular basis and the explanation of the Chartered Accountant cannot be accepted. It is also quite likely that the articled clerk would be availing leave quite often and coming late to the office.

Under the circumstances, the Chartered Accountant is guilty of misconduct for making a misstatement to the institute in regard to the discharge of his professional duties.

Note: Alternative Solution is possible as per Schedule II, Part II, Clause (3), a member is deemed to be guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false. In the instant case, X knew about the college timing of his articled assistant and he had given false information to the institute knowing them to be false and hence he will be deemed to be guilty of professional misconduct.

Question 132

The manager of ZedEx (P) Ltd. approached CA. Vineet in the need of a certificate in respect of a consumption statement of raw material. Without having certificate of practice (CoP), CA. Vineet issued the certificate to the manager of the company, acting as a CA in practice and applied for the CoP to the Institute on very next day to avoid any dispute.

Answer

Issuing Certificate without having Certificate of Practice: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council.

This clause requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

In the given case, CA. Vineet has issued a certificate in respect of a consumption statement of raw material to the manager of ZedEx (P) Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA. Vineet will be held guilty of professional misconduct in terms of Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act.

Question 133

Mr. Hopeful, an aspiring student of ICAI, approached Mr. Witty, a practicing Chartered Accountant, for the purpose of articleship. Mr. Witty, the principal, offered him stipend at the rate of ₹ 2,000

per month to be paid every sixth month along with interest at the rate of 10% per annum compounded monthly to compensate such late payment on plea that cycle of professional receipts from clients is six months. Mr. Hopeful agreed for such late payment in the hope of getting extra stipend in the form of interest.

Mr. Witty, however, used to disburse salary to all of his employees on time.

Answer

Contravening Provisions of the Act: A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct under Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

In the given case, Mr. Witty has failed to make the payments of stipend to articulated assistant every month in accordance with Regulation 48. The fact that the articulated assistant will be compensated with extra sum in the form of interest on late payment is not relevant and the plea that cycle of professional receipts from clients is six months is not acceptable as Mr. Witty has disbursed salary to all of his employees on time.

Therefore, Mr. Witty is guilty of professional misconduct under Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 as he has contravened Regulation 48 by not making the payment every month.

Question 134

AB & Co., a firm of Chartered Accountants, included the name of P as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co.

Answer

Submitting False Information to the Institute: Under Clause (3) of Part II of Second Schedule to the Chartered Accountant Act, 1949, a Chartered Accountant whether in practice or not is guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Directors (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case A B & Co. included another Chartered Accountant name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute. In fact such a member was not a partner of the said firm on the date of application. He will be held guilty of professional misconduct.

Question 135

Mr. P and Mr. Q are running a firm of Chartered Accountants in the name of M/s PQ & Co. On 23.05.2020, they included the name of Mr. R, a practicing Chartered Accountant, without his knowledge, as a partner while submitting an application for empanelment as auditor for Public Sector Bank branches to the Institute. However, they added Mr. R as a partner to their firm offering a share of 25% of the profits, on 25.05.2020.

Answer

Submitting Wrong Information to the Institute: As per Clause (3) of Part II of the Second

Professional Ethics

Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case, Mr. P and Mr. Q, partners of M/s PQ & Co., included the name of Mr. R, another Chartered Accountant, as partner in their firm, without his knowledge, in their application for empanelment as auditor of branches of Public Sector Banks submitted to the Institute. However, such a member was not a partner of the said firm as on the date of application submitted. Here, Mr. P and Mr. Q have submitted wrong information to the Institute.

Therefore, Mr. P and Mr. Q, both, would be held guilty of professional misconduct under Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.

Council General Guidelines

Question 136

Mr. C accepted the statutory audit of M/s PSU Ltd., whose net worth is negative for the year 2018-19. The audit was to be conducted for the year 2019-20. The audited accounts for the year 2019-20 showed liability for payment of tax audit fees of ₹ 15,000 in favour of Mr. E, the previous auditor.

Answer

Accepting Appointment as an Auditor: As per Chapter 7 of Council General Guidelines 2008, 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 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 2018-19.

Question 137

M/s PQR, a firm of Chartered Accountants with 5 partners has accepted the audit of ABC Pvt. Ltd. for 2019-20 at an audit fee of ₹ 2,500. ABC Pvt. Ltd. was incorporated in April, 2017, but had commenced operations in January, 2020.

Answer

Minimum Audit Fee: Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s PQR, a firm of Chartered Accountants having 5 partners, of ABC Pvt. Ltd. for audit fees of ₹ 2,500 is not violation of any provisions.

Therefore M/s PQR will not be held liable for guilty of misconduct.

Question 138

M/s LMN, a firm of Chartered Accountants having 5 partners accepts an audit assignment of a newly formed private limited company for audit fees of ₹ 5,000.

Answer

Minimum Audit Fee: Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s LMN, a firm of Chartered Accountants having 5 partners of a newly formed private limited company for audit fees of ₹ 5,000 is not violation of any provisions.

Therefore, M/s LMN will not be held liable for guilty of misconduct.

Question 139

Write a short note on Record of Audit Assignments (as required by ICAI regulations).

Answer

Record of Audit Assignments: In exercise of the powers conferred by Chapter 8 of Council General Guidelines 2008, the Council of the Institute of Chartered Accountants of India specified that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the “specified number of audit assignments of the companies under Section 224 and / or Section 228 of the Companies Act, 1956 (now under Section 141(3)(g) and 143 of the Companies Act, 2013) . As a part of this clause, to meet its requirements, a Chartered Accountants in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in guidelines issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:

S. No.	Name of the Company	Registration Number	Date of appointment	Date of Acceptance	Date on which Form 23-B filed with Registrar of Companies

[It may be noted that new Form ADT-1 is required to be filed with the Registrar as per the provisions and rules made under the Companies Act, 2013 in place of Form 23-B]

Question 140

L, a chartered accountant did not maintain books of account for his professional earnings on the ground that his income is less than the limits prescribed u/s 44AA of the Income Tax Act, 1961.

Answer

Maintenance of Books of Account: As per the Council General Guidelines 2008, under Chapter 5 on maintenance of books of accounts, it is specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct. Accordingly, it does not matter whether section 44AA of the Income Tax Act, 1961 applies or not. Hence, Mr. L is guilty of professional misconduct.

Question 141

A is the auditor of Z Ltd., which has a turnover of ₹ 200 crore. The audit fee for the year is fixed at ₹ 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 ₹ 1 crore. A seeks your advice on accepting the assignment.

Answer

Appointment as a Statutory Auditor of a PSUs’/Govt Company(ies)/Listed Company(ies) and Other Public Company(ies): As per the Council General Guidelines 2008, under Chapter IX on appointment as statutory auditor a member of the Institute in practice shall not accept the appointment as a statutory auditor of a PSUs’/Govt company(ies)/Listed company(ies) and other public company(ies) having a turnover of ₹ 50 crores or more in a year and where he 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. For this purpose the other work/services includes Management

Consultancy and all other professional services permitted by Council excluding audit under any other statute, Certification work required to be done by the statutory auditor and any representation before an authority.

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 ₹ 1 crore.

Question 142

D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the audit fees of ₹ 25,000 on progressive basis in respect of the tax audit for the year ended 31.3.2020. The audit report was, however, signed on 25.5.2020.

Answer

Entire Audit Fees Received in Advance: As per Chapter X of Council General Guidelines, 2008 a member of the Institute in practice or a partner of a firm in practice or a firm shall not accept appointment as auditor of a concern while indebted to the concern or given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding ₹10,000/-.

However, the Research Committee of the ICAI has expressed the opinion that where in accordance with the terms of engagement of auditor by a client, the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job, he cannot be said to be indebted to the company at any stage.

In the instant case, Mr. D is appointed to conduct a tax audit u/s 44AB of the Income Tax Act, 1961. He has received the audit fees of ₹ 25,000 in respect of the tax audit for the year ended 31.3.2020 which is on progressive basis. Therefore, Mr. D will not be held guilty for misconduct.

Question 143

Mr. E, proprietor of M/s. E & Co. is the statutory auditor of a Company which owns a store dealing in computer equipments. During the year 2019-20, E purchased a computer from the store costing ₹ 25,000 for his son. He did not make any payment for the same, but asked the company to adjust the same against the audit fees payable of ₹ 50,000.

Answer

Independence of Auditor: The guidance note on "Independence of Auditors" issued by the ICAI in this context recommends that "a question of indebtedness may also be raised where an auditor of a company purchases goods or services from the company audited by him. In such a case, if the amount outstanding exceeds ₹ 1,000, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditor as contained in sec 226(3) of the Companies Act, 1956 will be attracted." Now this limit has been increased from ₹ 1,000 to ₹ 5,00,000 as per the provisions of the Section 141(3)(d)(ii) of the Companies Act, 2013.

This provision will be applicable in the case of purchase of Computer for his son or for personal work by the auditor of a company on normal terms and conditions of the business of the company if the amount outstanding at the end of the year exceeded the prescribed limit which is ₹ 5,00,000.

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

Therefore, the contention of Mr. E that he does not incur disqualification is correct as he has

purchased a computer of the value of ₹ 25,000 which is not exceeding the prescribed limit and asked the company to adjust the same against the audit fees payable of ₹50,000.

Accordingly, Mr. E is not disqualified to be appointed as auditor of the company as he is indebted to the company for an amount not exceeding ₹ 5,00,000. Thus, Mr. E will not be held liable for guilty of professional misconduct.

Question 144

CA. Smart, a CA in practice runs his proprietorship firm as “M/s Smart & Co.”. His annual gross receipts are in excess of ₹ 40 Lakhs. He maintains a small pocket diary in which he writes the fees received from various clients. Based on his record, he prepares and files his income tax return.

Answer

Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner shall maintain and keep in respect of his/its professional practice, proper books of accounts including the following:

- (i) a Cash Book
- (ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain books of accounts. In the instant case, CA. Smart does not maintain books of accounts and writes the fees received from various clients in small pocket diary. A small pocket diary maintained by him cannot be books of accounts.

Hence, Mr. Smart, being a practicing Chartered Accountant will be held guilty for professional misconduct for violation of Council General Guidelines, 2008.

Question 145

CA. Elegant is in practice for two years and runs his proprietorship firm in the name of “Elegant & Co.”. He maintains notes in his mobile in which he writes the fees received from various clients. Based on his record, he prepares and files his income tax return.

Answer

Maintenance of Books of Account by a CA in Practice: Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his/its professional practice, proper books of accounts including the following-

- (i) a Cash Book
- (ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain proper books of accounts.

In the instant case, CA. Elegant does not maintain proper books of accounts and writes the fees received from various clients in notes in his mobile. Notes maintained by him in mobile cannot be treated as books of accounts.

Hence, CA. Elegant, being a practicing Chartered Accountant will be held guilty of misconduct for violation of Council General Guidelines, 2008.

Question 146

MNC Pvt. Ltd. appointed CA. Posh for some professional assignments like company’s ROC work,

preparation of minutes, statutory register etc. For this, CA. Posh charged his fees depending on the complexity and the time spent by him on each assignment.

Later on, MNC Pvt. Ltd. filed a complaint against CA. Posh to the Institute of Chartered Accountants of India (ICAI) that he has charged excessive fees for the assignments comparative to the scale of fees recommended by the Committee as well as duly considered by the Council of ICAI.

Answer

Charging Excess Fees: The prescribed scale of fees for the professional assignments done by the chartered accountants is recommendatory in nature. Charging an excessive fee for a professional assignment does not constitute any misconduct in the context of the provisions of the Chartered Accountants Act, 1949 and regulation made thereunder since the matter of fixation of actual fee charged in individual cases depends upon the mutual agreement and understanding between the member and the client.

In the given case, CA. Posh has charged excess fees comparative to the scale of fees recommended by the Committee as well as duly considered by the Council of ICAI. In this context, it may be noted that the scale of fees is the minimum prescribed scale of fees.

From the above facts and provisions, it may be concluded that CA. Posh is not liable for any misconduct under the Chartered Accountants Act, 1949. Therefore, the contention of MNC Pvt. Ltd. is not tenable.

Question 147

WCP & Co LLP are the internal auditors of DEF Ltd. WCP & Co LLP also agreed to undertake Goods and Service Tax (GST) Audit of DEF Ltd simultaneously.

Answer

The Council of the Institute, while considering the issue whether an internal auditor of an entity can also undertake GST Audit of the same entity as required under the Central Goods and Service Act, 2017, decided, that internal auditor of an assessee, whether working with the organization or independently practising Chartered Accountant being an individual chartered accountant or a firm of chartered accountants, cannot be appointed as his Tax auditor (under the Income Tax Act, 1961). Upon consideration, the Council decided that based on the conflict in roles as statutory and internal auditor simultaneously, the bar on internal auditor of an entity to accept tax audit (under Income Tax Act, 1961) will also be applicable to GST Audit (under the Central Goods and Service Act, 2017). Accordingly, an Internal Auditor of an entity cannot undertake GST Audit of the same entity.

In the instant case, WCP & Co LLP are the internal auditors of DEF Ltd. and it also agreed to undertake Goods and Service Tax (GST) Audit of DEF Ltd simultaneously. WCP & Co LLP will be held guilty for misconduct.

Question 148

Mr. X, a Chartered Accountant in Practice filed his income tax return for the Assessment Year 2020-21 under section 44ADA of the Income Tax Act, 1961, declaring his income on presumptive basis. In a disciplinary proceeding against him for an alleged misuse of funds of his clients, it was asked that he should submit his books of accounts for the financial year ended on 31/03/2020. Mr. X refused to submit books of accounts on the ground that he had not maintained any books and even for income tax purposes, he submitted his Return of Income on a presumptive basis. Is he right in

putting such a defence? Analyse the issues in the light of Professional Code, if any.

Answer

Maintenance of Books of Account: As per the Council General Guidelines 2008, under Chapter 5 on maintenance of books of accounts, it is specified that if a chartered accountant in practice or the firm of Chartered Accountants of which he is a partner fails to maintain and keep in respect of his/its professional practice, proper books of account including the Cash Book and Ledger, he is deemed to be guilty of professional misconduct.

Accordingly, it does not matter that as per section 44ADA of the Income Tax Act Mr. X declared his income on presumptive basis. Here, it may be noted that though 44ADA of the Income Tax Act exempt the requirement of books and accounts but as per Council General Guidelines a chartered accountant in practice is required to maintain and keep proper books of accounts including cash book and ledger. Hence, Mr. X is guilty of professional misconduct.

Question 149

M/s PQR & Co. is a partnership firm of 3 partners P, Q and R. All partners are exclusively associated with the firm in practice and are not doing practice in individual capacity. For the year ended 31st March, 2020, the partners have undertaken audits and signed audit reports under section 44AB / 44AD of the Income Tax Act 1961 as under:

Under section	44AB	44AD
P	10	15
Q	60	5
R	100	5

Discuss whether there is any professional misconduct by the partners of the firm in regard to the aforesaid audits.

Answer

Tax Audit assignments under Section 44 AB of the Income-tax Act, 1961: As per the Council General Guidelines 2008, under Chapter VI, a member of the Institute in practice shall not accept, in a financial year, more than the “specified number of tax audit assignments” under Section 44AB of the Income-tax Act, 1961.

For the above purpose, “the specified number of tax audit assignments” means (a) in the case of a Chartered Accountant in practice or a proprietary firm of Chartered Accountant, 60 tax audit assignments, in a financial year, whether in respect of corporate or non - corporate assesses. (b) in the case of firm of Chartered Accountants in practice, 60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

In computing the “specified number of tax audit assignments”, the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other Chartered Accountant in practice or firm of such Chartered Accountants, shall be taken into account.

Where any partner of the firm is also a partner of any other firm or firms of Chartered Accountants in practice, the number of tax audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the “specified number of tax audit assignments” in the aggregate.

In addition, where any partner of a firm of Chartered Accountants in practice accepts one or

more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the “specified number of tax audit assignments” in the aggregate.

It may be noted that the audits conducted under Section 44AD, 44AE and 44AF of the Income Tax Act, 1961 shall not be taken into account for the purpose of reckoning the “specified number of tax audit assignments”.

In the instant case, M/s PQR & Co., is a partnership firm of Partner P, Q and R. All the partners are exclusively associated with the firm and are not doing practice in individual capacity. Here, in the instant case, 60 tax audit assignments per partner in the firm, in a financial year will be considered for “specified number of tax audit assignments” i.e. $180 \text{ tax audits} = 3 \text{ Partners} \times 60 \text{ tax audits}$.

In the given situation, number of tax audit reports signed under section 44AB are 170 (i.e. 10 reports signed by Mr. P, 60 reports signed by Mr. Q and 100 reports were signed by Mr. R). and

number of tax audit reports signed under section 44AD are 25 (i.e. 15 reports signed by Mr. P, 5 reports signed by Mr. Q and 5 reports were signed by Mr. R). It may be noted that the 25 audits conducted under Section 44AD, of the Income Tax Act, 1961 shall not be taken into account for the purpose of reckoning the “specified number of tax audit assignments”.

In view of above provisions, partner Mr. P, Mr. Q and Mr. R of PQR & Co. have undertaken 170 audits which is not more than 180 tax audits i.e. “specified number of tax audit assignments” under Section 44AB of the Income-tax Act, 1961. Therefore, there is no professional misconduct in regard to the above said audits.

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