

## PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

### QUESTIONS

#### Standards on Auditing, Statements and Guidance Notes

1. (a) 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 2013-14. 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.
    - (I) 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.
    - (II) Explain the responsibility of auditors, in case, report made by Mr. Y's actuary, later on, found faulty.
  - (b) Yummy Ltd., dealing in manufacturing and trading of milk butter, has a benchmark in its product for so many years. Tasty Ltd., a rival company to Yummy Ltd., has introduced its new product, peanut butter. Due to being health conscious, the consumers have shifted from milk butter to peanut butter within few months. This has result into massive loss during the year to Yummy Ltd. due to non-selling of perishable milk products. The company has also started having negative net worth. It's production head, finance head and marketing head have also left the company. The company has no sound action plan to mitigate these situations. Kindly guide the auditor of Yummy Ltd., how he should deal with the situation.
2. 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 2013-14. 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?

### Audit Strategy, Planning and Programming

3. Your firm has been appointed as an auditor of YSPPP Ltd. The company operates 30 petrol stations throughout India. You are the senior in-charge of the audit for the year ending 31<sup>st</sup> March, 2014 and are engaged on the audit planning. The company's sites are long-established and supplying fuel, oil, air and water.

Over the last few years, due to the intense price competition in petrol trading, the company has expanded its shops into mini-markets with a wide range of motor accessories, food, drinks and household products. The induction of mini-markets has increased the volume of cash transactions. This induction has also lead to scarcity of staff at each and every location. For that reason, part-time staffs are also recruited.

Point-of-sale PCs have been installed at all the petrol stations, linked on-line via a network to the computer at head office. Sales and inventory data are entered directly from the PCs at branches.

The company has an internal auditor, whose principal function is to monitor continuously and test the operation of internal controls throughout the organization. The internal auditor is also responsible for coordinating the year-end inventory count.

#### Requirements:

Prepare notes for a planning meeting with the audit partner which-

- (a) Identify, from the situation outlined above, circumstances particular to YSPPP Ltd. that should be taken into account while planning the audit, explaining clearly why these matters should be taken into account.
- (b) Describe the extent to which the work performed by the internal auditor may affect your planning, and the factors that could limit the use you may wish to make of his work.

### Risk Assessment and Internal Control

4. (a) State briefly ten provisions of the Sarbanes-Oxley Act, 2002, which shall, if strictly applied to Indian Corporate, get successful results.
- (b) There are many objectives to maintain internal control systems. These include to ensuring that:
- (i) Transactions are executed through management authorization.
  - (ii) All transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets.
  - (iii) Assets and records are safeguarded from unauthorized access, use or disposition.
  - (iv) Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies.

In case of absence of internal control system, errors, omissions, or misappropriation of assets are likely to occur. Therefore, auditors need to pay meticulous attention to both the designing and operation of internal control.

You are required to:

- (i) Describe the types of errors, omissions or misappropriation of assets that can occur, in the perspective of trade receivables, where internal controls are fragile.
- (ii) Give some examples of matters which auditor may consider while determining the significant deficiencies in internal control.
- (iii) Explain, how an auditor may determine, while doing Risk Assessment, whether any risk is a significant risk.
- (iv) Illuminate important points which an auditor need to keep in mind with regard to letter of weakness in internal control system.

#### **Audit under CIS Environment**

5. MW&F Associates has been appointed as an auditor of a Multinational Company TTS Ltd. The company is working in a CIS environment. You are a member of the audit team of MW&F Associates. The partner in charge of MW&F Associates wants you to train your audit team member about use of Computer Assisted Auditing Techniques (CAATs). You are required to:
  - (a) Explain the factors that a statutory auditor has to consider, in determining, whether to use Computer Assisted Auditing Techniques (CAATs).
  - (b) Indicate the control procedures which the auditor should adopt in applying CAAT (Computer Assisted Audit Technique) in an audit under CIS environment.

#### **The Company Audit & Audit Report**

6.
  - (a) M/s Renault & Co., Chartered Accountants, appointed as a statutory auditor of R Ltd. for the financial year 2013-14. The company is also in need of some actuarial services. Consequently, the Board of Directors of the company offered the same to M/s Sona & Co., an associate to M/s Renault & Co., which has been duly accepted by the firm. Comment.
  - (b) Navy and Cavy Associates, a Chartered Accountant firm, has been appointed as Statutory Auditor of Poor Ltd. for the financial year 2013-2014. 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.
  - (c) Orange Ltd. is an unlisted public company. Its balance sheet shows paid up share capital of ₹ 5 crore and public deposits of ₹ 100 crore. The company appointed M/s Santra & Co., a chartered accountant firm, as the statutory auditor in its annual general meeting held at the end of September, 2014 for 11 years.

You are required to state the provisions related to- rotation of auditor 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.

- (d) 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?
7. Comment on the following situations:
- (a) Zank 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 31<sup>st</sup> March, 2014 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.
- (b) Mr. SB, a practicing Chartered Accountant, was appointed by CON Ltd. as Statutory Auditor. While doing the audit of CON Ltd., Mr. SB 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.
- (c) Gracious Ltd. has made a contribution of ₹ 7.8 lacs during the financial year ended 31.3.14 to Samaj Seva Party, a political party, for running a teaching institute situated in the rural area, where most of the workers of the company reside. It is admitted that the benefit of the institute is mostly for the children of the workers of the company. The average net profit of the company during the three immediately preceding financial years was ₹ 100 lakhs.
- (d) A firm of a father and a son is receiving ₹ 1 lakh towards job work done for ABC Ltd. during the year ending on 31.03.14. The total job work charges paid by ABC Ltd. during the year are over ₹ 25 lakhs. The father is a Managing Director of ABC Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction explicitly. He further contended that such a payment made in the last year was also not disclosed. Is Managing Director right in his approach?
- (e) Divergence Pvt. Ltd. is an unlisted closely held company with turnover less than ₹ 50 crores. While finalizing the accounts, Mr. Nix, Director (finance), disputed the

applicability of AS 20 to the company, on the basis of the fact that the company's shares are not listed on any recognised stock exchange in India.

8. (a) Mr. Man is a whole-time director of Manthan Ltd. who has a very good relation with the Director (Operations) of the company. Consequently, he entered into a purchase contract for supply of goods of ₹ 5,00,000 with the company without obtaining prior consent of the Board. What is the responsibility of the auditor in relation to the Companies Act, 2013?
- (b) Mr. A, a practicing Chartered Accountant, audited the financial statements of C Ltd. for the previous year 2012-13 and expressed an unmodified opinion. C Ltd. was of the view that Mr. A is not conducting the audit properly and therefore, for the current year 2013-14, it appointed Ms. B, a leading practicing Chartered Accountant to conduct the audit and present Comparative Financial Statements. Ms. B, while performing the auditing procedures, found that C Ltd. has undercharged the wages of ₹ 10 lakhs during the previous year resulting in overstatement of profits. What are the further procedures, Ms. B is required to pursue?
- (c) PK Ltd. has taken a term loan from a nationalized bank in 2012 for ₹ 350 lakhs repayable in 7 equal yearly instalments (including interest) of ₹ 50 lakhs beginning from 31<sup>st</sup> March, 2013 onwards. It had repaid the instalments due in 2013 & 2014, but defaulted in repayment of principal as well as interest for the current financial year 2015. Discuss the reporting responsibilities of the auditor of PK Ltd. in accordance with the Companies Act, 2013.
- (d) The Balance Sheet of G Ltd as at 31<sup>st</sup> March, 2015 is as under. Comment on the presentation in terms of Schedule III and Accounting Standards.

Heading	Note No.	31 <sup>st</sup> March, 15	31 <sup>st</sup> March, 14
<b>Equity &amp; Liabilities</b>			
Share Capital	1	XXX	XXX
Reserves & Surplus	2	0	0
Employee stock option outstanding	3	XXX	XXX
Share application money	4	XXX	XXX
<b>Non-Current Liabilities</b>		XXX	XXX
Deferred tax liability (Arising from Indian Income Tax)	5	XXX	XXX
<b>Current Liabilities</b>			
Trade Payables	6	XXX	XXX
<b>Total</b>		XXXX	XXXX
<b>Assets</b>			
Non-Current Assets			

Fixed Assets-Tangible	7	XXX	XXX
CWIP (including capital advances)	8	XXX	XXX
<b>Current Assets</b>			
Trade Receivables	9	XXX	XXX
Deferred Tax Asset (Arising from Indian Income Tax)	10	XXX	XXX
Debit balance of Statement of Profit and Loss		<u>XXX</u>	<u>XXX</u>
<b>Total</b>		<u>XXXX</u>	<u>XXXX</u>

### Liabilities of Auditor

9. (a) A Chartered Accountant in practice has been appointed as an auditor of a company which raised finance from the capital market on the basis of a prospectus issued a few years back. The main object for raising the finance was specified to be setting up a project on information technology.

The company advanced the sum so raised to various firms and private companies in which the directors of the company were a partner or a director respectively. These parties had no standing whatsoever with information technology. In the Balance Sheet, these advances appeared as a current asset under the head "Short-term Loans and Advances – unsecured, considered good". There was no mention to the notes to accounts about nature and purpose of such advances; and the auditor has issued routine audit report without any qualifications. On the very next day to the issuance of audit report, the directors and their related parties gone disappeared. The company, in which the auditor was conducting audit, has just vanished.

You are required to state whether the auditor will be held guilty for professional misconduct? Is there any liability subsists under any law?

- (b) 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.

### Audit Committee & Corporate Governance

10. (a) (i) Briefly explain the term 'Corporate Governance'.
- (ii) You are required to elucidate the functions of the Audit Committee as per section 177 of the Companies Act, 2013.
- (b) Disgust Limited, a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India the revenue of the company is going down and there is slowdown in other activities of the company. Therefore, it was expected that there would not be significant work for members of the Audit Committee.

Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet only once at the year end. They reviewed monthly information system of the Company and found no errors.

As an auditor of Disgust Limited would you consider the decision taken by the Audit Committee to hold the meeting once in a year, is complying with the Clause 49 of the (SEBI) Listing Agreement? Also state the quorum requirements for such meetings.

#### **Audit of Consolidated Financial Statements**

11. H Ltd. owns 55% 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. H Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. As a Statutory Auditor, how would you deal?

#### **Audit of Banking Company & General Insurance Company**

12. (a) You have been appointed as an auditor of Universal Bank, a nationalized bank. Universal Bank majorly 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?
- (b) Ordinary Insurance Ltd. has made a provision of 25% on unexpired risks reserve in its books. Comment.

#### **Audit of Non Banking Financial Companies**

13. (a) An auditor has been appointed for the audit of a loan financing company, registered as an NBFC. You are required to state special points to be kept in mind while auditing such company.
- (b) You are the auditor of IJK Ltd., an NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it?

#### **Audit under Fiscal Laws**

14. As a tax auditor, how would you report on the following situations?
- (a) Mr. Bhupesh, is a renowned criminal lawyer, practising in Meerut. During the previous year, he collected service tax of ₹ 25 lakhs but utilized it for his personal use. The Commissioner of Central Excise 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 service tax 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.

- (b) 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 2013-14. 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.
- (c) M/s. N.S. Enterprises, a manufacturing concern, sold a house property in Mumbai for a consideration of ₹ 48 lakh, to Mr. Gunaj on 1.8.2014. M/s. N. S. Enterprises had purchased the house property in the year 2012 for ₹ 40 lakh. The stamp duty value on the date of transfer, i.e., 1.8.2014, is ₹ 85 lakh for the house property.
- (d) 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

- (e) Saurabh International Ltd. (SIL) was engaged in providing certain services on which it did not pay any service tax. As per SIL, said services were not liable to service tax. However, Department issued a show cause notice to SIL demanding service tax 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 service tax and it has also filed an appeal for the same.

### Cost Audit

15. (a) PS Ltd., a foreign company, having place of business in Delhi, is engaged in the production, trading, import and export of orthopaedic implants and pacemaker (temporary and permanent, both). The company's revenue from export is usually in foreign currency. Its total revenue classification for the current financial year is provided below:

Intra-state Sale                      ₹ 140 lakhs

Inter-state Sale	₹ 155 lakhs
Export to US	₹ 490 lakhs
Export to UK	₹ 690 lakhs
Total Revenue	₹ 1475 lakhs

The management of the company is of the opinion that the company is not required to maintain cost records in their books of accounts. Consequently, there is no need to appoint cost auditor and conduct cost audit.

You are required to:

- (i) Guide the management of the company with regard to maintenance of cost records and its audit.
  - (ii) Explain the manner of maintaining cost records briefly.
- (b) Elucidate the provisions relating to submission of Cost Audit Report - to the Board and the Central Government as per the Companies Act, 2013.

#### **Audit of Public Sector Undertakings**

16. (a) Mr. X has been appointed as an Auditor of PSU Ltd., a Public Sector Undertaking, for the financial year 2014-15, though, government auditing is not his forte.

Thus, being an expert in the field of government audit, you are required to briefly explain him, the provisions related to the audit of government companies as per the Companies Act, 2013.

- (b) Briefly explain the Areas of propriety audit under Section 143(1) of the Companies Act, 2013.

#### **Internal Audit, Management and Operational Audit**

17. (a) 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-

- (i) 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.
  - (ii) who can be appointed as Internal Auditor?
- (b) The operational auditor of a company observed a totaling error in invoice of ₹ 500. He has not taken care of the same saying that this is out of scope of his work. Comment.

### Investigation and Due Diligence

18. (a) Your client is considering taking over a manufacturing concern and desires, in the course of due diligence review, you to look specifically for any hidden liabilities and overvalued assets. State the major areas you would scrutinize for the above.
- (b) Briefly explain the investigation into the affairs of a company as envisaged under Section 210 of the Companies Act, 2013.

### Professional Ethics

19. Comment on the following with reference to the Chartered Accountants Act, 1949, and Schedules thereto:
- (a) Mr. Clever, a Chartered Accountant, prepared a project report for one of his client, Mr. King, to obtain long term loan of ₹ 100 lakhs from a scheduled bank and decided to charge fees @10% of the loan approved. Subsequently, the bank approved the loan amounting to ₹ 80 lakhs. Consequent to the approval of loan by the bank, Mr. Clever raised an invoice for his services @10% of the loan approved, as decided.
- (b) 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.
- (c) A special notice has been issued for a resolution at 3<sup>rd</sup> 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.
- (d) 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.

### Other Miscellaneous Chapters

20. Write short notes on the following:
- (a) Types of Market under NEAT System.
- (b) Powers and duties of an auditor of a Multi-state Cooperative Society.
- (c) General steps to be followed while conducting a risk based audit.
- (d) Areas of Control for Reporting Stage of Peer Review.

## SUGGESTED ANSWERS/HINTS

1. (a) (I) **Difference of Opinion Among Joint Auditors:** SA 299 on, "Responsibility of Joint Auditors" 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.

- (II) **Using the work of an Auditor's Expert:** 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.

- (b) **Inability to Continue as a Going Concern:** 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, Yummy Ltd. has suffered massive loss due to introduction of a substitute of its product by its rival company, Tasty Ltd., and having negative net worth also. Besides this, its production head, finance head and marketing head have also left the company. The company, in addition, has no 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 from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold 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 or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

2. (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.

3. (a) **Planning an Audit:** As per SA 300 "Planning an Audit of Financial Statements", the objective of the auditor is to plan the audit so that it will be performed in an effective manner. For this, the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit and that guides the development of the audit plan. The auditor is also required to update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

In the instant case, YSPPP Ltd. is a company which operates 30 petrol stations throughout India. The company's sites are long-established and supplying fuel, oil, air and water. Over the last few years, due to the intense price competition in petrol trading, the company has expanded its shops into mini-markets as discussed in question. This induction has also lead to scarcity of staff; therefore, part-time staffs were also recruited. Point-of-sale PCs are also linked on-line via a network to the computer at head office. However, sales and inventory data are entered directly from the PCs at branches.

Circumstances particular to YSPPP Ltd. that should be taken into account while planning the audit, along with explanation for consideration is as under:

Circumstances	Why taken into account
➤ Multiple business locations.	➤ Increases inherent risk (e.g. if the organizational structure is loose and difficult to manage).
➤ Intense price competition.	➤ May lead to uneconomic price discounting, possibly threatening viability of business.
➤ Recent expansion of outlets into mini-markets.	➤ Increases complexity of business and may lead to loss of management control.

➤ Perishable nature and limited shelf-life of food and drinks inventories.	➤ Increase risk of over statement of inventory values.
➤ Large volume of cash transactions.	➤ Increases risk of incomplete income recording.
➤ Nature of the business (garage environment).	➤ Increases risk of loss of inventories and cash due to theft or staff pilferage. ➤ May limit effectiveness of physical security controls (e.g. over access to terminals).
➤ Direct input via PCs at branches.	➤ Increases risk of misstatement, as batch controls will not be feasible and scope for other input controls may be limited.
➤ Small number of staff at each location (e.g. one or two).	➤ Limits scope for segregation of duties within branches and therefore increases control risk.
➤ Branch-based nature of business.	➤ Limits effectiveness of management control over activities of individual branches thereby increasing control risk.
➤ Use of part-time staff and high staff turnover.	➤ May inhibit effectiveness of controls within branches.

**(b) Effect of Work of Internal Auditor on Audit Planning:**

- (i) The internal auditor's identification and documentation of areas of weakness will give direction to areas requiring increased substantive procedures.
- (ii) Work of the internal auditor may assist in selection of branches for audit visits, (e.g. where control failures have occurred).
- (iii) The internal auditor may attend year-end inventory counts at one or more branches, potentially reducing the number of branches to be visited by us.
- (iv) Work performed by the internal auditor may provide evidence to confirm operation of control procedures, on which we may seek to rely to reduce the extent of our own procedures.
- (v) Documentation of systems and controls by the internal auditor may reduce extent of our planning visits, as walkthrough checks may be sufficient to confirm systems documentation.

4. (a) **Following are some Provisions of the Sarbanes-Oxley Act of 2002, which, if enacted in India may be fruitful in respect of Indian corporate:**
- (i) More independence be given to Audit Committee and Auditor.
  - (ii) Ban on personal loan to Directors / Executive Officers of a Company.
  - (iii) Strict reporting by an auditor on insider trading.
  - (iv) Additional disclosures imposed on financial reporting.
  - (v) If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
  - (vi) Higher penalties and criminal prosecution on financial frauds.
  - (vii) To include effectiveness of Internal Control System in the financial reporting.
  - (viii) More responsibilities must be imposed on managerial personnel with higher penalties and prosecutions on the breach.
  - (ix) Strict action against white collar crime.
  - (x) Disclosures of the % of shareholdings by Directors, Executive Officers and principal shareholders.
- (b) (i) **Types of Error, Omission or Misappropriation Which Can Occur in the Area of Trade Receivables, Where Internal Controls are Fragile, are provided below:**
- (1) Invoices raised for incorrect amounts- Invoices may be raised at lower price. This may particularly occur when there is a conspiracy between the sales department and the customer. This misappropriation may understate the trade receivables.
  - (2) Invoices raised to incorrect customers- Goods may be sold to customers without verifying their credit worthiness. There is greater possibility of dues being converted into bad debts.
  - (3) Failure to record invoice- The sales department may forget to record the invoice. This is an error of omission. This will lead to understatement of sales and trade receivables along with overstatement of closing inventory.
  - (4) Invoices recorded in different customer name- The invoices may be recorded in different customer name. There shall not be any discrepancy in total of trade receivables balance, but individual trade receivable account will not tally.
  - (5) Failure to record amount received from trade receivable- It may happen that the finance manager failed to record the amount received in cash. This omission may occur when amount received but not in office hours, amount received by the person not authorised to receive, amount

received but not knowing on whose behalf, etc. This will lead to understatement of cash balance and overstatement of trade receivable balances.

- (6) Inadequate follow up for recovery of dues- Regular follow up is required for recovery of dues from the customers. Absence of which, convert the dues receivable into bad debts. This leads to unnecessary loss of profit.

- (ii) **Matters considered for determining Significant Deficiencies in Internal Control:** As per SA 265, "Communicating Deficiencies in Internal Control to those Charged with Governance and Management", significant deficiency in internal control means a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

**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.

- (iii) **Significant Risk:** As per SA 315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", significant risk is an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

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:

- (1) Whether the risk is a risk of fraud;
- (2) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (3) The complexity of transactions;
- (4) Whether the risk involves significant transactions with related parties;
- (5) 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
- (6) 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.

- (iv) **Letter of Weakness:** Material weaknesses are defined as absence of adequate controls on flow of transactions that increases the possibility of errors and frauds in the financial statements of the entity. The auditor should communicate such 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.
5. (a) **Consideration of Factors in Use of CAATs:** In determining whether to use CAATs, the auditor should consider the following factors:
- (i) Availability of sufficient IT knowledge and expertise- It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAAT. The audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted.
  - (ii) Availability of CAATs and suitable computer facilities and data in suitable format- The auditor may plan to use other computer facilities when the use of CAATs on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package programme and entity's computer.
  - (iii) Impracticability of manual tests due to lack of evidence- Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve, amounts of data that would overwhelm any manual procedure.
  - (iv) Impact on effectiveness and efficiency in extracting a data- It includes selection of samples, applying analytical procedures, time involved in application of CAAT, etc.
  - (v) Time constraints in certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.
- (b) **Control Procedure While Applying Computer Assisted Auditing Techniques (CAATs):** Computer Assisted Auditing Techniques (CAATs) involve performing audit procedures while conducting audit through the computer. Audit software and Test Data are two common types of CAATs. Using CAATs involves taking various measures including monitoring so that the use of CAATs by the auditor provides reasonable assurance that the audit objectives and detailed specifications of CAATs have been met. It is to be seen that CAATs are not manipulated by staff of the entity. The specific procedures necessary to control the use of CAATs will depend on the particular application.

**Procedures Carried Out by the Auditor to Control CAATs Applications may include:**

- (i) participating in the design and testing of CAAT;
- (ii) checking, if applicable, the coding of the program to ensure that it conforms with the detailed program specifications;
- (iii) asking the entity's staff to review the operating system instructions to ensure that the software will run in the entity's computer installation;
- (iv) running the audit software on small test files before running it on the main data files;
- (v) checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete;
- (vi) obtaining evidence that the audit software functioned as planned, for example, by reviewing output and control information; and
- (vii) establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

When using a CAAT, the auditor may require the cooperation of the entity's staff who have extensive knowledge of the computer installation. In such circumstances, the auditor should have reasonable assurance that the entity's staff did not improperly influence the results of the CAAT.

6. (a) **Services Not To Be Rendered By Auditor:** This provision is newly inserted by section 144 of the Companies Act, 2013. Section 144 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 whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Additionally, in accordance with section 141(4) of the Act, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned above 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 given case, M/s Renault & Co., Chartered Accountants, was appointed as an auditor of R Ltd. Further, the company offered actuarial services to M/s Sona & Co., an associate to M/s Renault & Co., which has also been duly accepted by the firm. Therefore, M/s Renault & Co. is disqualified to hold office as an auditor of R Ltd. under section 141(3)(i), as its associate is involved in providing such services, to R Ltd., as mentioned in section 144 of the Companies Act, 2013.

Subsequently, M/s Renault & Co. shall have to vacate the office of auditor of R Ltd. accordingly.

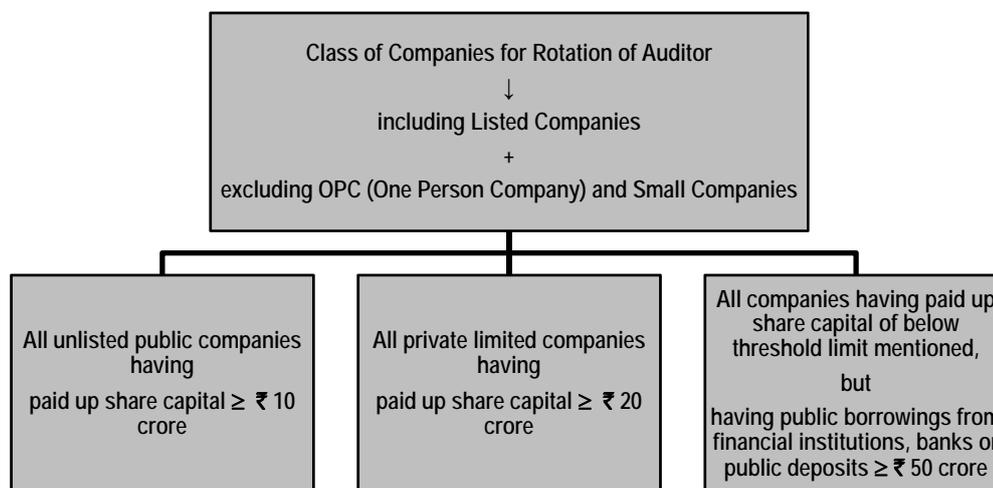
- (b) **Indebtness to the Subsidiary Company:** As per sub-section (3)(d)(ii) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is indebted 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.

- (c) **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 ₹ 20 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, Orange Ltd. is an unlisted public company having paid up share capital of ₹ 5 crore and public deposits of ₹ 100 crore. The company has appointed M/s Santra & Co., a chartered accountant firm, as the statutory auditor in its AGM held at the end of September, 2014 for 11 years.

The provisions relating to rotation of auditor will be applicable as the public deposits exceeds ₹ 50 crore. Therefore, Orange Ltd. can appoint M/s Santra & Co. as an auditor of the company for not more than one term of five consecutive years twice i.e. M/s Santra & Co. shall hold office from the conclusion of this meeting upto conclusion of sixth AGM to be held in the year 2019 and thereafter can be re-

appointed as auditor for one more term of five years i.e. upto year 2024. 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 Santra & Co. made by Orange Ltd. for 11 years is void.

**Cooling off period:** As per the proviso to section 139(2) of the Companies Act, 2013-

- (1) an individual auditor who has completed his term under clause (a) shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of his term;
- (2) an audit firm which has completed its term under clause (b), shall not be eligible for re-appointment as auditor in the same company for 5 years from the completion of such term.

Therefore, M/s Santra & Co. shall not be re-appointed as Auditor in Orange Ltd. for further term of 5 years i.e. upto year 2029.

- (d) **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.

7. (a) **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:
    - (1) Balances with banks;
    - (2) Cheques, drafts on hand;
    - (3) Cash on hand;
    - (4) 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.

- (b) **Enquiring into 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 the 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.

Clause (a) of Section 143(1) requires the auditor to enquire: “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 needs to enquire 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 enquired 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 enquire "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.

In the instant case, Mr. SB, the statutory auditor of CON Ltd., needs to enquire in the light of above provisions. If, as a result of the enquiries, he is satisfied then there is no further duty to report on these matters and if not, then he may report accordingly.

- (c) **Restrictions Regarding Political Contribution:** Section 182 of the Companies Act, 2013 deals with prohibitions and restrictions regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. In other cases, aggregate contribution in any financial year should not exceed 7½ % of average net profit during the three immediately preceding financial years.

In the given case, Gracious Ltd. has made a contribution of ₹ 7.8 lacs to Samaj Seva Party, a political party. The average net profit of the company during the three immediately preceding financial years is ₹ 100 lakhs and the 7½ % of this works out to ₹ 7.5 lacs.

As the company has contributed ₹ 7.8 lacs, there is a violation of the provisions of Section 182 of the Companies Act, 2013 although the children of its workers are benefited. Therefore, the auditor would have to qualify his report accordingly.

- (d) **Related Party Disclosures:** As per definition given in the AS 18 "Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, the managing director of ABC Ltd. is a partner in the firm with his son which has been paid ₹ 1 lakh as job work charges. The managing director is having a substantial holding in ABC Ltd. The case is squarely covered by AS 18. According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

- (i) the name of the transacting related party;
- (ii) a description of the relationship between the parties;
- (iii) a description of the nature of transactions;
- (iv) volume of the transactions either as an amount or as an appropriate proportion;
- (v) any other elements of the related party transactions necessary for an understanding of the financial statements;
- (vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
- (vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on Related Parties, also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied with in accordance with the AS 18. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report. Also it has to be seen whether section 184 of the Companies Act, 2013 regarding disclosure of interest by director has been complied with. If it is not complied with, the auditor needs to modify the report appropriately.

- (e) **Applicability of Accounting Standard:** AS 20, "Earning Per Share", came into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. As such AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the

requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

Further, Part II of Schedule III to the Companies Act, 2013, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part II of Schedule III to the Companies Act, 2013, should calculate and disclose earning per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

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

8. (a) **Responsibility of Auditor in Relation to the Companies Act, 2013:** As per Section 188 of the Companies Act, 2013, no company shall enter into any contract or arrangement with a related party to sale, purchase or supply of any goods or materials, except with the consent of the Board of Directors given by a resolution at a Board Meeting. Further, it is provided that no contract or arrangement, in the case of a company having specified paid-up share capital, or transactions exceeding prescribed sum, shall be entered into except with the prior approval of the company by a special resolution.

The contracts or arrangements mentioned above are those for which the register(s) are maintained under section 189 of the Companies Act, 2013. The scope of the auditor's inquiry under this clause is restricted to such transactions referred to in sections 184 and 188 of the Act.

The auditor should, while reporting, in the first instance, determine whether the aggregate value of all the transactions entered into with any of the companies/firms/parties covered in the register maintained under section 189 of the Act exceed the value of rupees five lakhs in the year. If so, the auditor has to examine whether each of the transactions entered into with such a company/firm/party have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Further, the auditor while reporting should clearly bring out the reasons as to why no adverse comment was considered necessary.

The contracts referred to in section 188 are for sale, purchase or supply of any goods, materials or services and contract of underwriting the subscription of any securities or derivatives of the company between a Company and its director or, its relative, a firm in which the director or relative is a partner, any other partner in such a firm or a private company of which the director is a member or director. The auditor will have to obtain the list of such parties which are covered by section 188 mentioned above.

Hence, the auditor should ensure that all the above mentioned provisions have been complied with.

(b) **Misstatement in Prior Period Financial Statements Audited by a Predecessor Auditor:** According to SA 710 “Comparative Information—Corresponding Figures and Comparative Financial Statements”, if the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period’s financial statements, the auditor shall state in an Other Matter paragraph:

- (1) That the financial statements of the prior period were audited by a predecessor auditor;
- (2) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
- (3) The date of that report,

unless the predecessor auditor’s report on the prior period’s financial statements is revised with the financial statements.

However, if the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor’s report on the amended financial statements of the prior period, the auditor shall report only on the current period.

In the given case, Mr. A has issued an audit report without modification for the previous year 2012-13. While Ms. B found a material discrepancy of undercharging wages of ₹ 10 lakhs during the year 2012-13. Hence, Ms. B is required to communicate the matter to the management and request them to inform the same to Mr. A. After revision or non-revision of the prior period’s financial statements, Ms. B may report accordingly as stated above.

(c) **Reporting Requirement as per Schedule III to the Companies Act, 2013:** 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.

In the given case, PK Ltd. has taken a loan from a nationalized bank three years back in 2012. It was regular in payment of instalments (including interest) for last two years but defaulted for the current financial year 2015. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

*"PK Ltd. has taken a loan during the year 2012, from a nationalized bank amounting to ₹ 350 lakhs @ X% p.a. which is repayable by yearly installment of ₹ 50 lakhs for 7 years.*

*The company has defaulted in repayment of dues including interest to a nationalized bank during the financial year 2014-15 amounting to ₹ 50 lakhs which remained outstanding as at March 31, 2015."*

**(d) Following Errors are noticed in Presentation as per 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.
- (vi) Under the main heading of Non-Current Assets, Fixed Assets are further classified as under:
  - (1) Tangible assets
  - (2) Intangible assets
  - (3) Capital work in Progress (CWIP)
  - (4) Intangible assets under development.
 

Keeping in view the above, the CWIP shall be shown under Fixed Assets 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.
  - (5) 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.

9. (a) **Liability for Misconduct:** Schedule III to the Companies Act, 2013 requires specific disclosure of loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member. Thus, the company has failed to comply with the requirements of Schedule III vitiating true and fair view.

Further, the Companies Act, 2013 specifically deals with transactions in which particular directors are interested. Section 188 specifies that Board's consent is required for certain contracts to be entered into with related parties. Section 184 requires disclosure of interest by director and also lays down the procedure to be followed in this regard. Section 189 of the Companies Act, 2013 requires that every company shall keep one or more registers in which particulars of all contracts or arrangements, to which Section 184 or Section 188 applies, shall be entered separately.

Thus, it is quite natural that all these particulars should have been recorded in such registers since the company advanced monies to various parties "related" to directors.

In the given case, the company has advanced the sum to the parties that are related to the Directors of the company and showed the same under the head "Short-term Loans and Advances – unsecured, considered good" rather than specific disclosure under the notes to accounts. The auditor of the company also issued clean audit report without any qualifications. It appears that the auditor did not perform his duties properly.

Therefore, as per the explanation provided above, the auditor has specific obligation to report under the Companies Act, 2013. Thus, he is liable under the Companies Act, 2013 and may be penalized under section 147 since he has performed his duties in a negligent manner. Further, the auditor would also be held guilty for professional misconduct under Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 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.

- (b) **Criminal Liability of an Auditor under the Companies Act, 2013:** 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-

(1) which is false in any material particulars, knowing it to be false; or

(2) which omits any material fact, knowing it to be material,

he shall be liable under section 447.

**Punishment for Fraud** - As per Section 447 of the Companies Act, 2013, without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to 10 years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

It may be noted that where the fraud in question involves public interest, the term of imprisonment shall not be less than 3 years.

Explanation — For the purposes of this section—

(i) "fraud" in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;

(ii) "wrongful gain" means the gain by unlawful means of property to which the person gaining is not legally entitled;

(iii) "wrongful loss" means the loss by unlawful means of property to which the person losing is legally entitled.

10. (a) (i) **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.

The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. The Securities and Exchange Board of India (SEBI) with the objective to align its provisions to the recently notified provisions of the Companies Act, 2013, ('the Act') has specifically reviewed clause 49 of the Listing Agreement, to adopt leading industry practices on corporate governance and to make the corporate governance framework more effective. The revised clause 49 on corporate governance shall be applicable to all listed companies with effect from 1 October 2014, except for the clause relating to the constitution of a Risk Management Committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year.

Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc.

Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons thereof and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

A monitoring cell set up by SEBI, will assess compliance by companies with the requirements of clause 49 and report non-compliances to SEBI within 60 days from the end of each quarter. This shows the strong intent of SEBI to not only bring in regulations, but also put in place a monitoring mechanism.

**[Student may note that SEBI has revised Clause 49 vide its Circular dated April 17, 2014 with effect from 1<sup>st</sup> October 2014.]**

- (ii) **Functions of the Audit Committee as per Section 177 of the Companies Act, 2013:** The Audit Committee performs various important functions like investigating the matters referred by board, discuss about internal control system etc. Section 177 of the Companies Act, 2013 deals with the terms of reference as well as functions of the audit committee which are as under:
- (A) As per Section 177(4), every Audit Committee shall act according to the terms of reference specified in writing by the Board which includes—
- (1) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;
  - (2) review and monitor the auditor's independence and performance, and effectiveness of audit process;

- (3) examination of the financial statement and the auditors' report thereon;
  - (4) approval or any subsequent modification of transactions of the company with related parties;
  - (5) scrutiny of inter-corporate loans and investments;
  - (6) valuation of undertakings or assets of the company, wherever it is necessary;
  - (7) evaluation of internal financial controls and risk management systems;
  - (8) monitoring the end use of funds raised through public offers and related matters.
- (B) The Audit Committee may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.
- (C) The Audit Committee shall have authority to investigate into any matter in relation to the items specified referred above to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.
- (D) Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed.
- (b) **Holding of Meeting and Review Requirements as per Clause 49 of the (SEBI) Listing Agreement:** One of the requirement as stipulated under clause 49 [Clause 49 (III) (B)] (on which Section 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 lapse 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 members present.

In this case, Disgust Limited is a company incorporated in India and have 6 members in it's Audit Committee. Contention of audit committee members to meet only once due to recessionary conditions in India, at the year end is not in line with the clause 49 of the (SEBI) Listing Agreement .

Besides, there is a mandatory review requirement as per Clause 49 (III) (E), according to which the Audit Committee shall mandatorily review the following information:

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

In the instant situation, though, the Audit Committee has reviewed monthly information system, but, failed to comply with the above requirements mentioned at point no. 1 to 5 of Clause 49 (III) (E) of Listing Agreement.

**11. 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".

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 this case, H 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, however for the compliance of provisions related to consolidation of financial statements given under the Section 129(3) of the Companies Act, 2013 read with Companies (Accounts) Rules, 2014, H Ltd. is required to consolidate the financial statements as per the provisions on consolidated financial statements provided in Schedule III to the Act.

**(Note: Students are advised to refer Section 129(3) of the Companies Act, 2013 along with Rule 6 of the Companies (Accounts) Rules, 2014 for detailed understanding)**

12. (a) **Evaluation of Internal Control System in the Area of Credit Card Operations in 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 unutilized 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 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 reimbursements (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 of monitor and follow-up of customers' payments.
- (ix) Items overdue beyond a reasonable period should be identified and attended 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.

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

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

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

- (i) for marine hull insurance – 100% of net premium.
- (ii) For fire, marine cargo and miscellaneous business – 50% of net premium.

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

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

13. (a) **Audit of a Loan Financing Company:** Special points to be kept in mind while auditing a loan financing company, an NBFC, are given below:
- (i) 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.
  - (ii) 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.
  - (iii) Obtain balance confirmations from the concerned parties.
  - (iv) As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscouted 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.
  - (v) 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.
  - (vi) Check whether the NBFC has not advanced any loans against the security of its own shares.
  - (vii) In case of companies which are engaged in the business of providing short term funds in the ICD market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the credit worthiness of the clients prior to placed by the company are being rolled over and whether there is any risk of non-recovery. In addition, he should ascertain that the NBFC is receiving interest regularly in respect of these ICDs. Roll over of ICDs and non-realisation of interest and principal amounts should be thoroughly checked to determine whether the ICD is required to be treated as a NPA.
  - (viii) Auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyze the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
  - (ix) Check the classification of loans and advances (including bills purchased and discounted) made by an 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.

- (x) An auditor should also verify whether provision for bad and doubtful debts has been disclosed separately in the Balance Sheet and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.

**(b) 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.

14. (a) **Reporting Requirement Under Clause (4) of Form 3CD:** Mr. Bhupesh has defaulted in payment of service tax for the previous year. Consequently, the Commissioner of Central Excise 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 service tax 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 excise duty, service tax, 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 service tax registration number under Clause (4) of the Form 3CD. Thus, contention of Mr. Bhupesh not to disclose the service tax details is not tenable.

- (b) **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 2013-14. 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 twenty five 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 44AD, clause (d) 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).

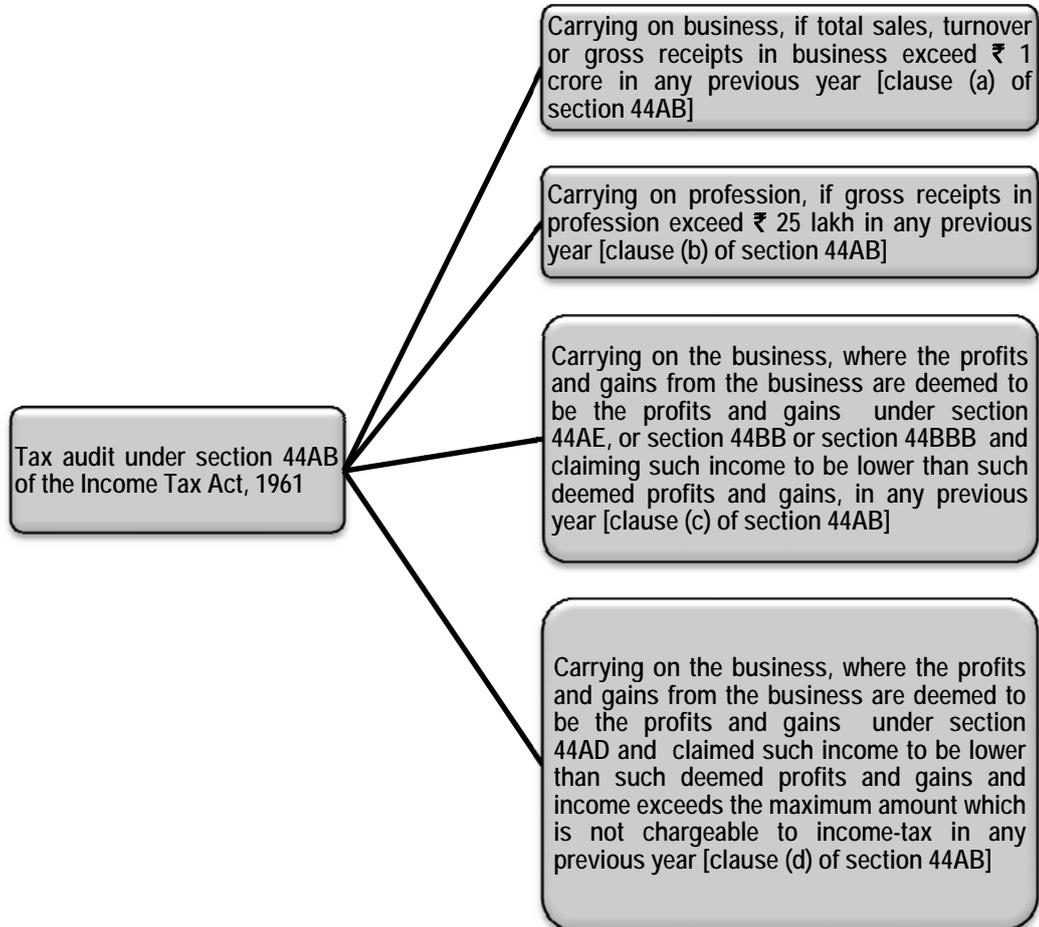


Diagram representing various clauses of section 44AB of the Income Tax Act, 1961 under which a tax audit is required to be conducted

**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.

- (c) **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.

- (d) **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.

- (e) **Reporting Requirement Under Clause (41) of Form 3CD:** In the instant case, Saurabh International Ltd. (SIL) is engaged in providing certain services on which it did not paid any service tax. Therefore Department issued a show cause notice and demand for Service Tax along with interest thereon. SIL has also filed an appeal mentioning that said services are not liable to service tax, 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 service tax 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 the 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.

15. (a) (i) **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 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 (including Foreign Companies) required to include cost records in their books of account. One of the types of companies prescribed under this rule is the company (including foreign company other than those having only liaison offices) engaged in the production, import and supply or trading of following medical devices, such as heart valves; orthopaedic implants; pacemaker (temporary and permanent).

However, the requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

- (1) whose revenue from exports, in foreign exchange, exceeds 75 per cent of its total revenue; or
- (2) which is operating from a special economic zone.

In the given case, PS Ltd. is a foreign company and engaged in the production, trading, import and export of orthopaedic implants and pacemaker (temporary and permanent, both). Its total revenue for the current financial year is ₹ 1475 lakhs, out of which, export, in foreign currency, comprises ₹ 1180 lakhs (₹ 490 lakhs + ₹ 690 lakhs). The proportion of the company's export to its total revenue is 80% [(₹ 1180 lakhs/ ₹ 1475 lakhs)\*100].

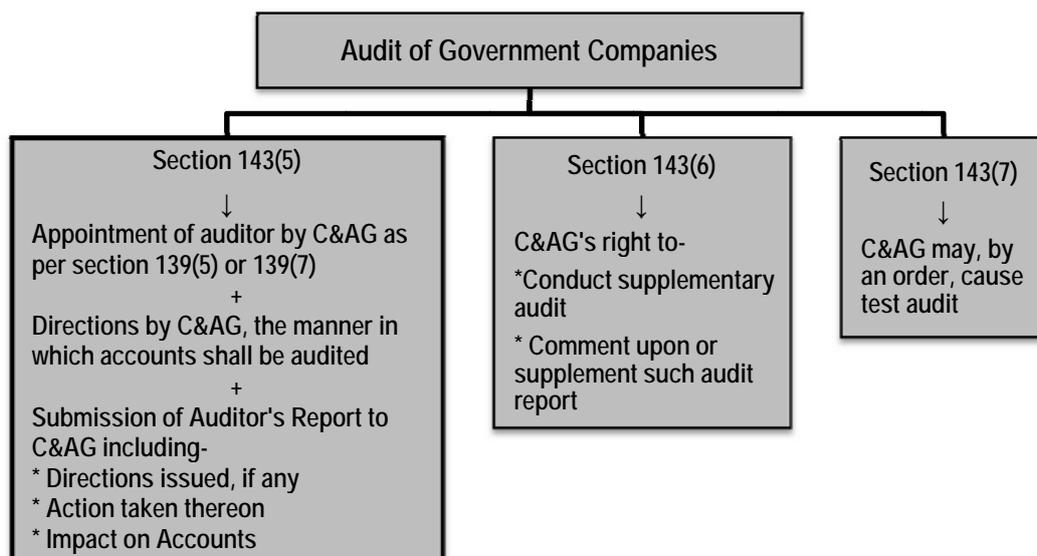
Therefore, PS Ltd. is required to include cost records in their books of account in accordance with Rule 3 of the Companies (Cost Records and Audit) Rules, 2014. However, the company is not required to conduct cost audit as its revenue from exports, in foreign exchange, exceeds 75 per cent of its total revenue.

- (ii) **Manner of Maintaining Cost Records-** Rule 5 of the Companies (Cost Records and Audit) Rules, 2014, requires every company under these rules including all units and branches thereof, to maintain cost records in Form CRA-1. The cost records shall be maintained on regular basis in such manner as to facilitate calculation of per unit cost of production or cost of operations, cost of sales and margin for each of its products and activities for every financial year on monthly or quarterly or half-yearly or annual basis.
- (b) **Manner of Submission of Cost Audit Report to the Board-** The cost auditor shall submit the cost audit report along with his or its reservations or qualifications or observations or suggestions, if any, in Form CRA-3. He shall forward his report to the Board of Directors of the company within a period of 180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

**Manner of Submission of Cost Audit Report to the Central government-** The company shall within 30 days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in Form CRA-4 along with fees specified in the Companies (Registration Offices and Fees) Rules, 2014. If, after considering the cost audit report referred to under this section and the information and explanation furnished by the company as above, the Central Government is of the opinion, that any further information or explanation is

necessary, it may call for such further information and explanation and the company shall furnish the same within such time as may be specified by that Government.

16. (a) Provisions related to Audit of Government Companies as per the Companies Act, 2013:



Following are the provisions related to 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 Company are appointed or re-appointed by the Comptroller and Auditor General of India. 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.

The C&AG may direct the appointed 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.

- (ii) **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.

- (iii) **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.
  - (iv) **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.
- (b) **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:
- (1) 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;
  - (2) 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;
  - (3) 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;
  - (4) whether loans and advances made by the company have been shown as deposits;
  - (5) whether personal expenses have been charged to revenue account;
  - (6) 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.

17. (a) (i) **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 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.

(ii) **Who can be Appointed as Internal Auditor?** As per section 138, the internal auditor shall either be a chartered accountant, whether engaged in practice or not, or a cost accountant, 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.

In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

(b) **Scope of Operational Audit:** Operational auditing is a systematic process involving logical, structured and organized series of procedures. It concentrates on effectiveness, efficiency and economy of operations and therefore it is future oriented. It does not end with the reporting of the findings but also recommends the steps for improvement in future.

The main objective of operational auditing is to verify the fulfillment 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. He will have to get the assistance of norms and standards in every operating field to be able to objectively judge a situation. The norms and standards should be such as are generally acceptable or developed by the company itself.

To a traditional internal auditor, a loss of ₹ 500 caused by a wrong totaling of invoice is important and this is that he looks for. But for an auditor engaged in the review of operations, carrying out of a proper maintenance programme of the machines is of greater importance because considerable production loss due to machine breaks down can thus be prevented. In both the cases, the auditor's objective is to see that the business and its profitability do not suffer from avoidable loss, but, nevertheless, there is a distinct difference in approach. But it should not be assumed, that, since an operational auditor is concerned with the audit of operations and review of operating conditions, he is not concerned with the financial aspects of transaction and controls.

Hence, contention of operational auditor that totaling error in invoice of ₹ 500 is out of scope is not correct as operational audit is being carried out to ensure that all the management functions like planning, organizing, staffing, directing and controlling are working effectively and efficiently. Such kind of error is very much in scope because such an existence of error indicates that control system (controlling function) is not sound.

18. (a) **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:**

- (i) The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- (ii) 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.
- (iii) 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.
- (iv) Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- (v) Tax liabilities under direct and indirect taxes.
- (vi) Long pending sales tax assessments.
- (vii) Pending final assessments of customs duty where provisional assessment only has been completed.
- (viii) Agreement to buy back shares sold at a stated price.
- (ix) Future lease liabilities.
- (x) Environmental problems/ claims/ third party claims.

- (xi) Unfunded gratuity/ superannuation/ leave salary liabilities; incorrect gratuity valuations.
- (xii) Huge labour claims under negotiation when the labour wage agreement has already expired.
- (xiii) Contingent liabilities not shown in books.

**The auditor shall have to specifically examine the following areas in the case of Overvalued Assets:**

- (i) Uncollected/uncollectable receivables.
  - (ii) Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
  - (iii) Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
  - (iv) 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.
  - (v) Litigated assets and property.
  - (vi) Investments carried at cost though realizable value is much lower.
  - (vii) Investments carrying a very low rate of income/ return.
  - (viii) Infructuous project expenditure/ deferred revenue expenditure etc.
  - (ix) Group Company balances under reconciliation etc.
  - (x) Intangibles of no value.
- (b) Investigation into the Affairs of a Company as Envisaged under Section 210 of the Companies Act, 2013:** Where the Central Government is of the opinion, that it is necessary to investigate into the affairs of a company-
- (i) on the receipt of a report of the Registrar or inspector;
  - (ii) on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated; or
  - (iii) in public interest,

it may order an investigation into the affairs of the company.

Further, where an order is passed by a court; or the Tribunal requiring investigation, the Central Government shall order an investigation into the affairs of that company.

For the above purposes, the Central Government would appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

- 19 (a) **Charging of Fees Based on Percentage:** As per Clause (10) 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 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.

In the given case, Mr. Clever has prepared a project report, to obtain a long term loan, for Mr. King. However, he decided to raise the invoice of his service @10% of the loan to be sanctioned in future, which is basically contingent upon the findings. Therefore, Mr. Clever will be held guilty for professional misconduct under the abovementioned clause.

- (b) **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.

- (c) **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.

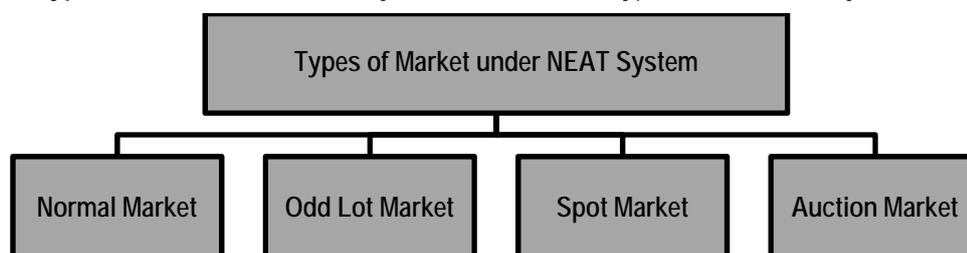
Therefore, CA Smart will not be held guilty for professional misconduct under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

- (d) **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.

20. (a) **Types of Market:** The NEAT system has four main types of market. They are-



**Normal Market:** All orders which are of regular lot size or multiples thereof are traded in the normal market. For shares which are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as regular lot orders, special

term orders, negotiated trade orders and stop loss orders, depending on their order attributes.

**Odd Lot Market:** An order is called an odd lot order if the order size is less than regular lot size; such orders are traded in the odd-lot market. These orders do not have any special terms or attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place.

**Spot Market:** Spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal market. These orders do not have any special terms or attributes attached to them.

**Auction Market:** In the auction market, auctions are initiated by the Exchange on behalf of trading members for completing the settlement process.

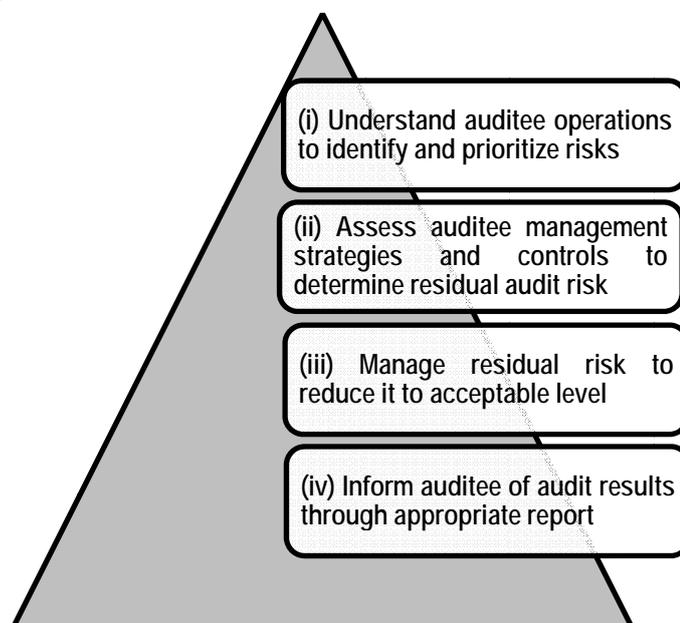
- (b) **Powers and Duties of an Auditor of a Multi-State Co-Operative Society:** Under Section 73 of the Multi-State Cooperative Societies Act, 2002, every auditor of a Multi-state Co-operative Society shall have a right of access at all times to the books, accounts and vouchers of the Multi-State Co-operative Society whether kept at the head office of the Multi-State Co-operative Society or elsewhere and shall be entitled to require from the officers or other employees of the Multi-State Co-operative Society such information and explanation as the auditor may think necessary for the performance of the duties as an auditor.

As per section 73(2), of the said Act, the auditor shall make the following inquiries:

- (i) Whether loans and advances made by the Multi-State Co-operative Society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State Co-operative or its members;
  - (ii) Whether transactions of the Multi-State Co-operative Society which are represented merely by book entries are not prejudicial to the interest of the Multi-State Co-operative Society;
  - (iii) Whether personal expenses have been charged to revenue account; and
  - (iv) Where it is stated in the books and papers of the Multi-State Co-operative Society 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.
- (c) **General Steps in the Conduct of Risk-Based Audit** – Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

RBA consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable

level and the reporting to auditee of audit results. These are achieved through the following:

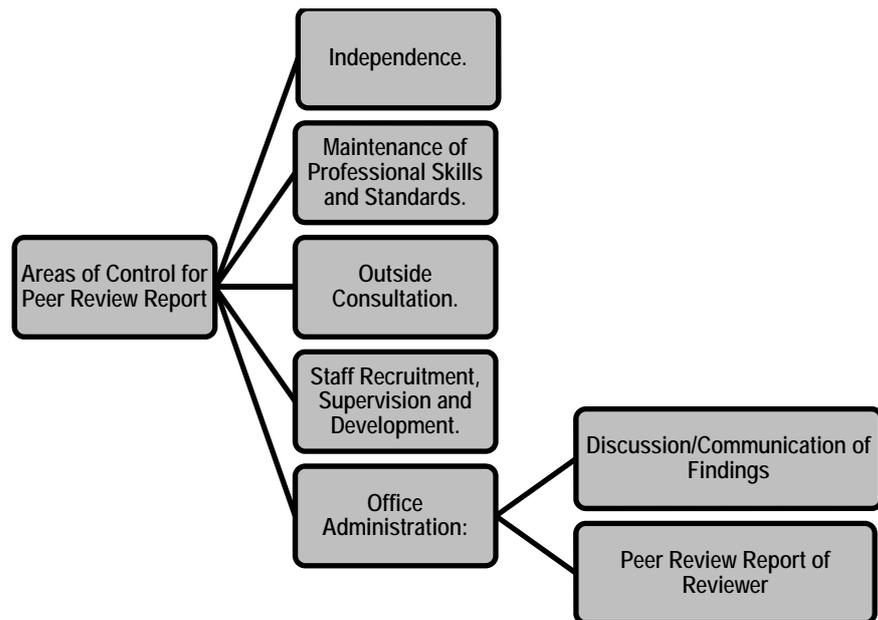


- (i) Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.
- (ii) Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.
- (iii) Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to

areas of high audit risks, which were earlier known through the analytical procedures undertaken.

- (iv) The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.
- (d) **Areas of Control for Reporting Stage of Peer Review:** The Peer Review Report should state that the system of quality control for the assurance services of the Practice Unit for the period under review has been designed so as to carry out the assurance services in a manner that ensures compliance with Technical, Professional and Ethical Standards.

The Peer Review Report shall address the compliance report or otherwise on the following areas of controls:



- (i) Independence.
- (ii) Maintenance of Professional Skills and Standards.
- (iii) Outside Consultation.
- (iv) Staff Recruitment, Supervision and Development.
- (v) Office Administration:
- (1) Discussion/Communication of Findings
- (A) After completing the on-site review, the Reviewer, before making his

Report to the Board, shall communicate his findings 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.

- (B) 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.
- (2) Peer Review Report of Reviewer
- (A) 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.
  - (B) 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, 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.
  - (C) 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 in (B) 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.