

## PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

### QUESTIONS

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

1. (a) CA Ashutosh has been appointed as an auditor of Awesome Health Ltd. for the financial year 2013-14 which was audited by CA Amrawati in 2012-13. As the Auditor of Awesome Health Ltd., state the steps that CA Ashutosh would take to ensure that the Closing Balances of the financial year 2012-13 have been brought to account in 2013-14 as Opening Balances and the Opening Balances do not contain any misstatements.
- (b) A Company outsourced the activity of accounting data maintenance to the Service Organisation to achieve cost reduction. As a Statutory Auditor of such company, what are the precautions/checks that you would consider for conducting the audit?
2. (a) While compiling the financial statements of Discrepancy Ltd., you observed that the information supplied by the company is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above situation.
- (b) While doing the audit of Prakash Ltd., CA Prateek, the auditor, requires reports from experts for the purpose of audit evidence. What type of reports/ opinions he can obtain and to what extent he can rely upon the same?

#### Audit Strategy Planning and Programming

3. You are the manager responsible for the audit of Value Ltd. which has a year end of 31 March. This is the first year that your firm has undertaken the audit of Value Ltd., having succeeded the previous auditors at the last annual general meeting following a successful tender for the audit. Your firm has an office in Mumbai and in 25 other location throughout the India.

You have had preliminary discussions with the management of Value Ltd. and obtained some background information about the company. The company produces fertilizer in a factory on the outskirts of Liverpool. The head office is situated in Mumbai. There are ten depots throughout the country which hold large stocks of fertilizer so that local demand for its products can be met quickly. Inventory records are not maintained and a full count is carried out at the year end.

You have also read recent government press release that indicates that 'L', a product which forms a major part of the company's sales, contains a chemical that has been identified as being potentially dangerous to those who handle it. An official government working party has been set up to review the situation.

#### Requirement

- (a) Identify the circumstances that should be taken into account when planning the audit of Value Ltd., and set out your outline audit approach in these areas.

- (b) Explain the objectives of audit planning.

#### **Risk Assessment and Internal Control**

4. You are the auditor of Vishakha Steel Pressing Limited, which manufactures small pressing from sheet-steel. The process generates scrap steel which is placed daily by the work force into a bin kept for that purpose in the yard. Every Friday a lorry arrives from a small local scrap merchant. The bin is loaded on to the lorry and replaced by an empty bin. The weight is obtained by the gatekeeper using the company weighbridge. He notes the weight in a book kept for that purpose in the gate office. Each month a cheque is received through the post from the scrap merchant accompanied by a remittance advice stating the weight of scrap collected, the price and the amount of the cheque. The cheque is banked by the cashier and the remittance advice is filed. There are no other procedures in this area:

You are required to:

- (a) Suggest major improvements to be made in the internal control in this area.  
 (b) Suggest key audit procedures under these circumstances to mitigate audit risk.

#### **Audit under CIS Environment and Special Audit Techniques**

5. (a) Zantacs, a limited company having turnover of approximately ₹ 80 crores uses a tailor made accounting software package. In the said package, all transactions are recorded, processed and the final accounts generated from the system. The management tells you that in view of the voluminous nature of day books, there is no need to print them and that audit can be conducted on the computer itself. The management further assures you that any 'query based reports' as required can be generated and printed. As a statutory auditor of the company, enumerate the procedures you would adopt to conduct the audit.  
 (b) "The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability" – Comment.

#### **The Company Audit**

6. As an auditor, how would you deal with the following situations:
- (a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2013-2014. Mr. Hanuman, a partner of the Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.
- (b) Nick Ltd. is a subsidiary of Ajanta Ltd., whose 20% shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nick Ltd. appointed Mr. Prem as statutory auditor for the year.
- (c) Contravene Ltd. appointed CA Innocent as an auditor for the company for the current financial year. Further the company offered him the services of actuarial,

investment advisory and investment banking which was also approved by the Board of Directors.

- (d) Mr. Amar, a Chartered Accountant, bought a car financed at ₹ 7,00,000 by Chaudhary Finance Ltd., which is a holding company of Charan Ltd. and Das Ltd. He has been the statutory auditor of Das Ltd. and continues to be even after taking the loan.

7. As an auditor, how would you deal with the following situations:

- (a) M/s XYZ & Co., auditors of Goodwill Education Foundation, a recognised nonprofit organisation feels that the standards on auditing need not to be applied as Goodwill Education Foundation is a non-profit making concern.
- (b) Rama Pvt. Ltd. is a private company having paid up share capital of rupees twenty-five crore but having public borrowing from nationalized banks and financial institutions of rupees forty crore. The company appointed CA Raman as an auditor in its AGM dated 29th September, 2014.

You are required to state the following provisions as the section 139 of the Companies Act, 2013 in case of an individual auditor or an audit firm, both-

- (i) Rotation of auditor;
- (ii) Cooling off period;
- (iii) Common partner(s) to the other audit firm whose tenure has expired;
- (iv) Transitional period for the adoption of new Companies Act;
- (v) Right of the company to remove an auditor;
- (vi) Rotation between partners of audit firm;
- (c) MSY & Co. is an Audit Firm having partners CA Mukti, CA Shakti and CA Yukti. CA Mukti, CA Shakti and CA Yukti are holding appointment as an Auditor in 4, 6 and 10 Companies respectively.
- (i) Provide the maximum number of Audits remaining in the name of MSY & Co.
- (ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. CA Mukti, CA Shakti, CA Yukti.
- (d) State the provisions relating to filling of casual vacancies as per section 139 (8) of the Companies Act, 2013 and casual vacancy due to resignation.

#### Liabilities of Auditor

8. Indicate the precise nature of auditor's liability in the following situations and support your views with authority, if any:
- (a) A misstatement had occurred in the prospectus issued by the company.
- (b) Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the

subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.

### **Audit Report**

9. (a) The auditor of Chand Ltd. did not report on the matters, specified under section 143(1) of the Companies Act, 2013, on which he inquired into, because of the reason that he was satisfied. But the management of the company wanted the auditor to report on those matters so that the members can also be aware of the true position of the company. Comment as to whether the auditor is required to report the matters, specified under the Act, he inquired into and whether the contention of the management is sustainable.
  - (b) An auditor became aware of a matter regarding a company, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion. Comment.
  - (c) The audit report of P Ltd. for the year 2012-13 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2013-14, how would you report, if the company does not make provision for doubtful debts in 2012-13?
  - (d) XYZ Ltd. Co. gave a donation of ₹ 50,000 each to a Charitable Society running a school and a trust set up for the service of Blind during financial year ending on 31st March, 2014. The average net profits of the company for the last three years were 15 lakhs. Comment.
10. State the matters to be specified in Auditor's Report in terms of provisions of Section 143(3) of the Companies Act, 2013.

### **Audit of Banking Company**

11. (a) As a branch auditor of a nationalised bank, how would you verify the following?
  - (1) Advances to DOT COM Companies.
  - (2) Balances in account of a bank situated in a foreign country.
- (b) As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances.

### **Audit of General Insurance Company**

12. Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.

### **Cost Audit**

13. You have been appointed as Cost Auditor of M/s PQR Ltd. State the functions of Cost Auditor in respect of the following:

- (i) Inventory
- (ii) Labour
- (iii) Overhead and indirect expenditure.
- (iv) Work in Progress

#### **Audit of Co-operative Societies**

14. Mention the duties of Auditor of Co-operative Societies in regard to the following:
- (a) Over-due interest.
  - (b) Compliance with provisions of Co-operative Act and Rules thereunder.
  - (c) Special Report to Registrar of Co-operative Societies.

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

15. (a) Concession Ltd. is engaged in the business of manufacturing of threads. The company recorded the turnover of ₹ 1.13 crore during the financial year 2013-14 before adjusting the following:

Discount allowed in the Sales Invoice	₹ 8,20,000
Cash discount (other than allowed in Cash memo/ sales invoice)	₹ 9,20,000
Trade discount	₹ 2,90,000
Commission on Sales	₹ 6,00,000
Sales Return (F.Y. 2012-13)	₹ 1,60,000
Sale of Investment	₹ 6,60,000

You are required to ascertain the effective turnover to be considered for the prescribed limit of tax audit under the relevant Act and guide the company whether the provisions relating to tax audit applies.

- (b) Mr. Verma carries on the business of dealing and export of diamonds. For the year ended 31<sup>st</sup> March 2014, you as the tax auditor find that the entire exports are to another firm in U.S.A. which is owned by Mr. Verma's brother. Comment.

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

16. You are the auditor of Sample Ltd., a NBFC registered with RBI. What is the procedure you would pursue to ensure that the NBFC Public Deposit Directions have been followed by Sample Ltd.?

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

17. (a) Interior Pvt. Ltd. is a manufacturing company having turnover of ₹ 210 crore but having maximum outstanding loan from public financial institution of ₹ 90 crore only during the preceding financial year. You are required to state whether the company is liable for internal audit as per the provisions of the Companies Act, 2013.

- (b) As an External auditor of Interior Pvt. Ltd., explain the important aspects to be considered in the evaluation of Internal Audit Function.

### Investigation and Due Diligence

18. Sri Ramaswami is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. C Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to C Ltd.?

### Professional Ethics

19. Comment on the following with reference to the Chartered Accountants Act, 1949, and Schedules to the Act:
- (a) CA N, in practice, started project consultancy work as a part of his practice and to advance the same, sent mail to all the CAs in the country informing them of his services and for securing professional work.
- (b) CA T, in practice, was appointed to carry out Internal audit of a stock broker, listed with BSE. However, he failed to intimate his appointment to the statutory auditors of the company. The statutory auditor feels this is violation of professional ethics.
- (c) Mr. Ram, a Chartered Accountant in practice, received ₹ 15,00,000 on 15th December, 2013 on behalf of one of his clients, who has gone to USA. Mr. Ram deposited the said amount in his saving bank account (SB Account). As per instruction of the client, the said amount is to be returned to the client on March 31, 2014 when he will return to India. On the occasion of birthday of his wife Sita, Mr. Ram withdrew ₹ 5,00,000 and spent on Birthday party. He re-deposited ₹ 5,00,000 in the said SB account on 25th March, 2014 and then returned the entire amount of ₹ 15,00,000 to the client on March, 31, 2014.
- (d) CA. Smart, a CA in practice runs his proprietorship firm as "M/s Smart & Co.". His annual gross receipts are in excess of ₹ 40 Lakhs. He maintains a small pocket diary in which he writes the fees received from various clients. Based on his record, he prepares and files his income tax return.

### Other Miscellaneous Chapters

20. Write short notes on the following:
- (a) Constitution of Audit Committee under Section 177 of the Companies Act, 2013.
- (b) Areas to be examined in Comprehensive Audit of public enterprises.
- (c) Souda Book.
- (d) Appointment of Auditor.
- (e) Collection of evidences by Peer reviewer.

## SUGGESTED ANSWERS/HINTS

1. (a) **Obtaining sufficient appropriate audit evidence while conducting Initial Audit Engagement** : According to SA 510 on "Initial Audit Engagements- Opening Balances", the objective of the Auditor while conducting an initial audit engagement with respect to opening balances is to obtain sufficient appropriate audit evidence so that the-
- (i) opening balances of the preceding period have been correctly brought forward to the current period;
  - (ii) opening balances do not contain any misstatement that materially affect the current period's financial statements; and
  - (iii) appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

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

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

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

- (b) **Precautions to be taken by auditor in case Accounting Data Processed by Service Organisation**: A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

SA 402 on "Audit Considerations relating to an Entity Using a Service Organisation" deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.

While planning the audit, the auditor of the client should determine the significance of the activities of the service organisation to the client and their relevance to the audit. In doing so, the auditor of the client would need to consider the following, as appropriate:

- (i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control.
  - (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.
  - (iii) The degree of interaction between the activities of the service organisation and those of the user entity.
  - (iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.
2. (a) **Compilation of Financial Information:** According to SRS 4410 "Engagement to Compile Financial Information", an accountant would normally have to rely on the management for most of the information needed to compile the financial statements or other financial information, including accounting estimates as well as the fact that the information given to the accountant is complete and reliable. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:
- (i) Make any enquiries of management to assess the reliability and completeness of the information provided;
  - (ii) Assess internal controls prevailing in the entity; and
  - (iii) Verify any matters or explanations.

If the accountant becomes aware that the information supplied by management is incorrect, incomplete, or otherwise unsatisfactory, the accountant should consider performing the procedures listed above and request management to provide additional information. This may be asked in the form of management representation letter covering significant information or explanations given orally on which he considers representations are required. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

The accountant should read the compiled information and consider whether it appears to be appropriate in form and free from obvious material misstatements. The identified financial reporting framework and any known departures therefrom should be disclosed within the financial information, though their effects need not be quantified.

- (b) As per SA 620, "Using the work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. While doing audit, CA Prateek, the auditor can obtain the following types of reports, or opinions or statements of an expert for the purpose of audit evidence:

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

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

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

### 3. Audit Planning

Circumstances	Outline audit approach
This is the first year that the firm has undertaken the audit of Value Ltd.	<ul style="list-style-type: none"> <li>• In order to be satisfied about the previous financial statements the auditor should :               <ol style="list-style-type: none"> <li>1. Hold consultations with management.</li> <li>2. Review client's records, working papers and accounting and control procedures for the previous period.</li> </ol> </li> </ul>

	<ol style="list-style-type: none"> <li>3. (Possibly) hold consultations with the previous auditor.</li> <li>4. Be familiarizing with the nature of the business, market, accounting systems etc by discussions with management and by review of interim/management accounts.</li> </ol>
<p>Value Ltd.has</p> <ul style="list-style-type: none"> <li>- A head office in Mumbai</li> <li>- A factory in Liverpool</li> <li>- Ten depots throughout the country</li> </ul>	<ul style="list-style-type: none"> <li>• The staff must be planned to carry out the audit from the firm's offices throughout the country.</li> <li>• They must all be adequately briefed and provided with a copy of the audit plan detailing their specific tasks and deadlines.</li> </ul>
No inventory records have been maintained but a full inventory count is to be carried out at the year end.	<ul style="list-style-type: none"> <li>• It is very important that the auditors are satisfied with the inventory count.</li> <li>• The written count instruction must be reviewed well in advance of the year end, so that improvement can be suggested by the auditors and incorporated into the client's instructions.</li> <li>• The auditors should ensure that sufficient staff with the necessary experienced is available to attend the count at all material locations.</li> </ul>
'L', a major product of the company, has been identified as being potentially dangerous.	<p>Ascertain</p> <ul style="list-style-type: none"> <li>- For how long Value Ltd. has been selling 'L'and in what quantity?</li> <li>- How much 'L' the company now holds in inventory?</li> </ul> <p>Ensure that the firm keeps up-to-date with the findings of the government working party.</p> <p>Consider whether any of the employees of Value Ltd. may have been harmed and, if so, the consequential liability of the company to them.</p>

**(b) Objectives of audit planning**

- (i) **To ensure that appropriate attention is devoted to important areas of the audit:** This is done via a formal written audit plan, laying down the objectives and the procedures to be followed in order to meet those objectives.
- (ii) **To facilitate review:** Work should be delegated to staff with the appropriate level of experience. All work should be properly supervised and reviewed by

amore senior member of staff.

(iii) **To ensure that potential problems are identified:** The auditor must ensure that resources are directed towards material/high risk areas.

(iv) **To assist in the proper assignment of work:** This may be to members of the audit team or to experts or other auditors. It helps the audit to proceed in a timely and efficient manner.

4. (a) **Improvements to be made in the internal control in this area:**

(i) Ensure that all scrap is put into the bin by the work force. This can be achieved by documenting the scrap generated in every production lot/shift/day.

(ii) Check should be available that the merchant is paying the best prices for the scrap. This can be achieved by getting a quote periodically from few dealers or getting market price and validation.

(iii) Ensure that quantity collected is paid for this can be achieved by company quantity lifted with the amount paid/quantity for which payment is received.

(iv) An independent official should attend the weighing and the enter in the book.

(b) **Key audit procedures under these circumstances to mitigate audit risk:**

(i) Budget figures should be prepared for waste and compared to actual waste and variance being investigated.

(ii) Compare remittance advices/related quantity and reconcile with the quantity in gate keeper's book.

(iii) Ensure all entries in the weight book is paid for.

(iv) Ensure all remittance matching entries in the cash book.

(v) Review the reasonableness of total scarp sold during the period by comparing with manufacturing records of steel used in processing.

5. (a) A key feature of the accounting software package used by the company definitely involves the absence of a clear audit trail. In other words, transactions cannot be easily traced or co-related from the individual supporting documents of those transactions. Moreover, the management does not wish to print the daybooks in view of the voluminous nature since it may involve extensive costs. This has naturally led to extensive dependence by management upon the "exception reporting" principle.

From the auditor's point of view, it must also be conceded, the exception reports in the form of 'query-based reports' which isolate the above data provide him with the very material that he requires for most of his verification work. The only problem which it raises, and it is a serious one, is that he cannot simply assume that the programmes which produce the exception reports are reliable in respect of the following factors:

(i) operating accurately;

- (ii) printing out all the exceptions which exist; and
- (iii) bound by programmed control parameters which meet the company's genuine internal control requirements.

In view of the above, whether management relies upon exception reports, it effectively eliminated the audit trail between input and output and the auditor is forced to test the invisible processes which purport to embody the controls, and produce the output such as it is. These tests, which invariably involve the use by the auditor of the computer itself, are known as tests through the machine. In the 'through the machine' approach, the auditor starts by proving the accuracy of the input data, and then thoroughly examines (by applying tests) the processing procedures with a view to establishing the following that:

- (i) all input is actually entered into the computer.
- (ii) neither the computer nor the operators can cause undetected irregularities in the final reports.
- (iii) the programmes appear, on the evidence of rejection and exception routines, to be functioning correctly.
- (iv) all operator intervention during processing is logged and scrutinised by the DP manager.

The auditor in such circumstances will have to first evaluate the existing controls. For the same, he has to do the following:

- (i) Evaluate the internal control system especially the controls and checks existing for recording the transactions, i.e., he has to verify at what level transactions can be entered into the system and what checks are available to prevent any unauthorised data entry and for rectifying errors/omissions in the transactions entered.
- (ii) Evaluate at what level there authority is given for modification of transactions already entered. Is there any authority given only to a senior employee to carry out modifications? Or is it that once transactions are entered and validated, no further modifications are possible thereto.
- (iii) Whether there is a provision in the software for carrying out an on line audit of transactions, i.e. whether there a separate module in the package, where a separate password given to the auditor and once he has seen and approved a particular transaction/set of transactions, the same would be locked and no modifications would be possible by anyone (including the senior most employee) in the company.
- (iv) Whether there are proper procedures for backup of data on a regular basis and whether the said procedures are being strictly followed.
- (v) In case of any loss of data whether there is a clear defined recovery procedure

to minimize the loss of data due to power failures or any human errors.

- (vi) The auditor may introduce some dummy data into the system and see the results obtained.

After the auditor has evaluated the above procedures, he has to prepare an audit plan depending on the results obtained from his earlier evaluation. Since the daybooks are not being printed, the plan can contain procedures wherein data is verified directly on the computer from the vouchers/invoices, etc. The audit plan will also require a lot of analytical procedures to be performed. Depending on the importance of various expense heads and other important account heads, the auditor will also obtain various reports from the system depending on various queries that he would have to identify. Some illustrative reports can be:

- (i) To check whether proper classification is done for revenue/capital - a report can be obtained of all purchases (not being raw materials or other routine purchases) exceeding ₹ one lakh.
- (ii) To check whether all freight outward bills are accounted for a report containing a month-wise co-relation between goods despatched and freight amount paid. The same can be further co-related with the freight rates obtained from the bills.

Once the auditor has performed the above procedures, he would be able to form an opinion whether reliance can be placed on the accounting systems and the data recorded. If the auditor finds that reliance cannot be placed on the systems he can inform the management about the fact and also that the daybooks, etc., will need to be printed to allow him to conduct the audit. The finalisation procedures to be followed even under this system would remain more or less similar to other accounting systems. The auditor can obtain reports of depreciation on fixed assets, inventory valuation and using the normal procedures find out whether reliance can be placed on them, e.g., if while valuing stocks the system is using the LIFO method, the same would not be acceptable and will need to be modified. Similarly depreciation calculations will have to be verified on a random basis to find out its reliability.

- (b) The reliability of a component is a function of control that acts on the component. In a computer system the following are the major types of controls and used to enhance component reliability which the auditor must evaluate:
- (i) **Authenticity Control:** They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)
- (ii) **Accuracy Control:** These attempts to ensure the correctness of the data and processes in a system (Programme validation check).
- (iii) **Completeness Control:** This ensures that no data is missing and all processing is carried through to its proper conclusion.
- (iv) **Privacy Control:** This ensures the protection of data from inadvertent or unauthorised disclosure.

- (v) **Audit Trail Controls:** This ensures the traceability of all events occurred in a system.
- (vi) **Redundancy Control:** It ensures that processing of data is done only once.
- (vii) **Existence Control:** It attempts to ensure the on going availability of all system resources.
- (viii) **Asset safeguarding controls:** It attempts to ensure that all resources within a system are protected from destruction or corruption.
- (ix) **Effectiveness Control:** It attempts to ensure that the system achieves its goals.
- (x) **Efficiency Control:** It attempts to ensure that a system uses minimum resources to achieve its goals.

6. (a) **Auditor holding securities of a company :** As per sub-section (3)(d)(i) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Provided that the relative may hold security or interest in the company of face value not exceeding rupees one lakh.

Also, as per sub-section 4 of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Hanuman, Chartered Accountant, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. Therefore, the firm, M/s Ram and Hanuman Associates would be disqualified to be appointed as statutory auditor of Krishna Ltd. as per section 141 (3)(d)(i), which is the holding company of Shiva Ltd., because Mr. Hanuman one of the partner is holding equity shares of its subsidiary.

- (b) According to Section 139 (7) of the Companies Act, 2013, the auditors of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. As per section 2(45), a Government company is defined as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company as thus defined”.

In the given case Ajanta Ltd is a government company as its 20% shares have been held by Central Government, 25% by U.P. State Government and 10% by M.P. State Government. Total 55% shares have been held by Central and State

governments. Therefore, it is a Government company.

Nick Ltd. is a subsidiary company of Ajanta Ltd. Hence Nick Ltd. is covered in the definition of a government company. Therefore, the Auditor of Nick Ltd. can be appointed only by C & AG.

Consequently, appointment of Mr. Prem is invalid and he should not give acceptance to the Directors of Nick Ltd.

- (c) Services not to be Rendered by the Auditor: Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

- (i) accounting and book keeping services;
- (ii) internal audit;
- (iii) design and implementation of any financial information system;
- (iv) actuarial services;
- (v) investment advisory services;
- (vi) investment banking services;
- (vii) rendering of outsourced financial services;
- (viii) management services; and
- (ix) any other kind of services as may be prescribed.

Further section 141(3)(i) of the Companies Act, 2013 also disqualify a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

In the given case, CA Innocent was appointed as an auditor of Contravene Ltd. He was offered additional services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors. The auditor is advised not to accept the services as these services are specifically notified in the services not to be rendered by him as an auditor as per section 144 of the Act.

- (d) According to section 141 (3)(d) (ii) of the Companies Act, 2013, a person is not eligible for appointment as auditor of any company, If he is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of rupees five lakh.

In the given case Mr. Amar is disqualified to act as an auditor under section 141 (3)(d) (ii) as he is indebted to M/s Chaudhary Finance Ltd. for more than 5'00'000 ₹ Also according to Section 141 (3)(d) (ii) he cannot act as an auditor of any subsidiary of Chaudhary Finance Ltd. i.e. he is also disqualified to work in Charan Ltd. & Das

Ltd. Therefore he has to vacate his office in Das Ltd. Even though it is a subsidiary of Chaudhary Finance Ltd.

Hence audit work performed by Mr. Amar as an auditor is invalid, he should vacate his office immediately and Das Ltd should appoint another auditor for the company.

7. (a) **Compliance with Standards on Auditing** : As per sub section 9 of section 143 of the Companies Act, 2013, every auditor shall comply with the auditing standards. Further as per sub section 10 of section 143 of the Act, the Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Provided that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

Further, the Preface to Standards on Auditing gives the scope of the Standards on Auditing. As per the Preface, the SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial statements/information of any entity; whether profit oriented or not and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon.

Also while discharging their attest function; it is the duty of the Chartered Accountant to ensure that SAs are followed in the audit of financial information covered by their audit reports.

In the given case, even though the client is a non-profit oriented entity the SAs shall apply and the auditor shall be guilty of professional misconduct for failing to discharge his duty in case of non-compliance with SAs.

- (b) (i) **Rotation of Auditor**: 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:-
- (a) all unlisted public companies having paid up share capital of rupees ten crore or more;
  - (b) all private limited companies having paid up share capital of rupees twenty crore or more;
  - (c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty 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 five consecutive years; and
- (b) an audit firm as auditor for more than two terms of five consecutive years.

In the given case, Rama Pvt. Ltd. is a private company having paid up share capital of rupees twenty-five crore but having public borrowing from nationalized banks and financial institutions of rupees forty crore. The company appointed CA Raman as an auditor in its AGM dated 29th September, 2014.

The provisions relating to rotation of auditor will be applicable as the paid up share capital exceeds rupees twenty crore. Therefore, Rama Pvt. Ltd. shall appoint CA Raman as an auditor of the company for not more than one term of five consecutive years and CA Raman will hold office of Auditor from the conclusion of this meeting upto conclusion of sixth AGM i.e. AGM to be held in the year 2019.

**(ii) 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 five 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 five years from the completion of such term.

Therefore, CA Raman shall not be re-appointed as Auditor in Rama Pvt. Ltd. for further term of five years i.e. he cannot be appointed as Auditor upto year 2024.

**(iii) Common partner(s) to the other audit firm whose tenure has expired:** As per the second proviso to section 139(2) of the Companies Act, 2013, as on the date of appointment, no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years. For Example, M/s XYZ & Co., is an audit firm having partner Mrs. X, Mr. Y and Mr. Z, whose tenure has expired in the company immediately preceding the financial year. M/s ABZ & Co., is another audit firm in which Mr. Z is a common partner, will also be disqualified for the same company along with M/S XYZ & Co. for the period of five years.

**(iv) Transitional period for the adoption of new Companies Act:** As per the third proviso to section 139(2) of the Companies Act, 2013, every company, existing on or before the commencement of this Companies Act, 2013 which is

required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within three years from the date of commencement of this Act. For example-

- (1) Mr Ram, a Chartered Accountant, is an individual auditor of M/s. Pinaco Ltd by last 5 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013), here a break in the term for a continuous period of five years will not be considered as fulfilling the requirement of rotation. Thus, Mr Ram can continue the audit of M/s. Pinaco Ltd. for another 3 years due to transitional effect, i.e. aggregate period in the same company will be 8 years.
- (2) M/s Ram Associates, a Chartered Accountants Audit Firm, is doing audit of M/s. Pinaco Limited by last 11 years as on March, 2013 (i.e. existing on or before the date of Commencement of Companies Act, 2013), here a break in the term for a continuous period of two terms of five consecutive years will not be considered as fulfilling the requirement of rotation. Thus, M/s Ram Associates can continue the audit of M/s. Pinaco Ltd. for another 3 years due to transitional effect, i.e. aggregate period in the same company will be 14 years.

(v) **Right of the company to remove an Auditor:** As per the fourth proviso to section 139(2) of the Companies Act, 2013, it has also been provided that right of the company to remove an auditor or the right of the auditor to resign from such office of the company shall not be prejudiced.

(vi) **Rotation between partners of audit firm:** Under section 139(3) of the Act, subject to the provisions of this Act, members of a company may resolve to provide that-

- (a) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or
- (b) the audit shall be conducted by more than one auditor.

Further, it is important to note that as per the section 139(4) of the Companies Act, 2013, the Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of section 139(2) of the Act.

(c) **Ceiling Number of Audit:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

As per section 141 (3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be  $3 \times 20 = 60$  company audits. Sometimes, a chartered accountant is a partner in a number of auditing

firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

In the given case, CA Mukti is holding appointment in 4 companies, whereas CA Shakti is having appointment in 6 Companies and CA Yukti is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

(i) Therefore, MSY & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm =  $20 \times 3 = 60$

Number of Audits already taken by all the partners

In their individual capacity =  $4+6+10 = \underline{20}$

Remaining number of Audits available to the Firm = 40

(ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) CA Mukti can hold:  $20 - 4 = 16$  more audits. (2) CA Shakti can hold  $20-6 = 14$  more audits and (3) CA Yukti can hold  $20-10 = 10$  more audits.

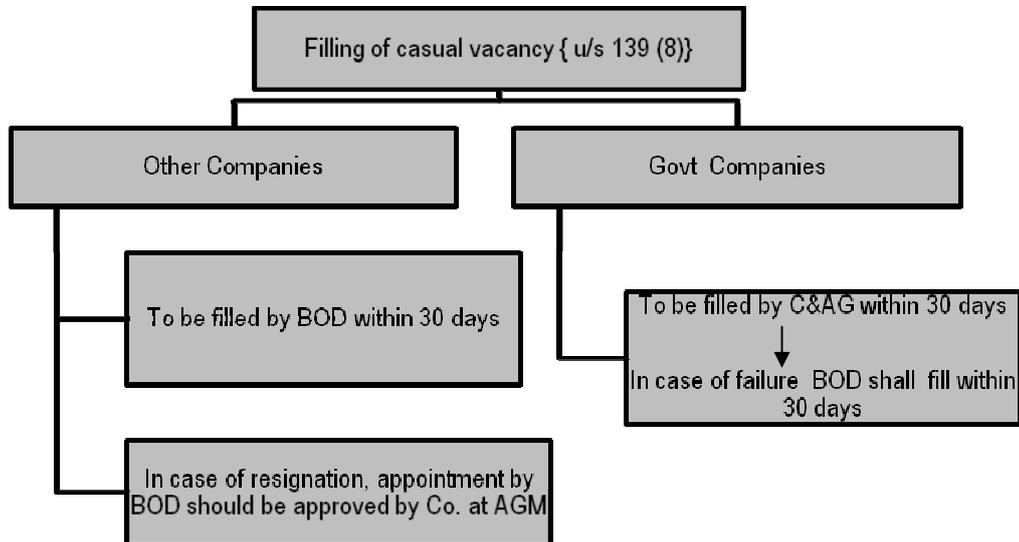
(d) As per Section 139(8), any casual vacancy in the office of an auditor shall-

(i) **In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Board of Directors within thirty days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;

(ii) **In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India**, be filled by the Comptroller and Auditor-General of India within thirty days:

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next thirty days.



**Casual Vacancy by Resignation:** As per section 140 (2) the auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in section 139(5) i.e. subsequent auditor of Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140 (3).

8. (a) Under section 35 (1) of the Companies Act, 2013, where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—
- (i) is a director of the company at the time of the issue of the prospectus;
  - (ii) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;
  - (iii) is a promoter of the company;
  - (iv) has authorised the issue of the prospectus; and
  - (v) is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

No person shall be liable under sub-section (1) of section 35, if he proves—(i) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or (b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) of section 35 shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

- (b) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the under noted considerations:
- (i) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and
  - (ii) Whether the statutory auditor properly and adequately extended the audit programme of the previous year having regard to the weaknesses noticed.

SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" clearly mentions that, "The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis". The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud or error. If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as

he determines to be appropriate. Thus, normally speaking, as long as the auditor took due care in performing the audit work, he cannot be held liable.

9. (a) **Reporting of Matters contained under Section 143(1) of the Companies Act, 2013:** Section 143(1) of the Act deals with the duties of an auditor requiring him to make an inquiry in respect of specified matters amongst other matters. The matters in respect of which the inquiry has to be made by the auditor are relating to loans and advances on the basis of security, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, personal expenses charged to revenue account etc. Since the law requires the auditor to make an inquiry, the Research Committee of 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 inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the inquiry, in deciding whether or not any reference needs to be made in his report.

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse. Consequently, the auditor of Chand Ltd. is correct in non-reporting on the matters specified in Section 143(1) of the Act and hence, the contention of the management is not sustainable.

- (b) Section 146 of the Companies Act, 2013 empowers the auditors of a company to attend any general meeting of the company; to receive all the notices and other communications relating to the general meeting, unless otherwise exempted by the company, and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

Where the auditor has reason to believe that the directors concealed deliberately a serious fact from the shareholders which came to his note after issuance of the audit report, he should exercise this right. Normally speaking, an auditor considers subsequent events only upto the date of issuance of the audit report.

The discovery of a fact after issuance of the financial statements that existed at the date of the audit report which would have caused the revision of the audit report, requires the auditor to bring this to the notice of shareholders.

Likewise, it may be advisable for the auditor to attend the meeting with a view to bringing to the notice of the shareholders any matter which came to his knowledge subsequent to his signing the report and if it had been known to him at the time of writing his audit report, he would have drawn up the report differently; or where the accounts have been altered after the report was attached to the accounts.

- (c) Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and

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

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

- (d) **Donation to Charitable Institutions:** Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent of its average net profits for the three immediately preceding financial years.

**Facts of the case:** In the instant case, the company has given donation of ₹ 50,000/- each to the two charitable organisations which amounts to 1,00,000. Assuming that the charitable organisations are not related to the business of the company, the average profits of the last 3 years is ₹ 15 lakhs and the 5% of this works out to ₹ 75,000. Hence the maximum of donation could be ₹ 75,000 only. For excess of ₹ 25,000 the company is required to take prior permission in general meeting which is not been taken.

**Conclusion:** By paying donations of ₹ 1,00,000 which is more than ₹ 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence the auditor should qualify his report accordingly.

10. **Duty to Report:** As per sub section 3 of section 143 of the Companies Act, 2013, the auditor's report shall also state –

- (a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;
- (d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (e) whether, in his opinion, the financial statements comply with the accounting standards;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (g) whether any director is disqualified from being appointed as a director under sub-section (2) of the section 164;
- (h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;
- (j) such other matters as may be prescribed.

Further, Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-

- (i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- (ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- (iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

**11. (a) (1) Advances to DOT COM Companies**

- (i) Evaluate the efficacy of internal control system in general to ascertain

whether an advance is made only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank. The sanction for an advance must specify, among other things, the limit of borrowing, nature of security, margin to be kept, interest, terms of repayment, etc. Also see that all the necessary documents, e.g., agreements, demand promissory notes, letters of hypothecation, etc. have been executed by the parties before advances are made.

- (ii) Examine loan documents such as certificate of commencement of business, resolution of board of directors, and resolution of shareholders.
- (iii) Verify the business plan of the company especially where the revenue model is in place. Verify whether the company depends only on outside funding or can self generate funds.
- (iv) Examine in case the security is in the form of mortgage, apart from mortgage deed (in the case of English Mortgage) or letter of intent to create mortgage (in the case of Equitable Mortgage), the evidence of registration of the charge with the Registrar of Companies.
- (v) Review the operation of advance account to see that limit is not generally exceeded; that the account is not becoming stagnant; that the customer is not drawing against deposits which are not free from lien; that the account is not window-dressed by running down overdrafts at the year end and again drawing further advances in the new year, etc.
- (vi) Examine whether there is a healthy turnover in the account. It should be seen that the frequency and the amounts of credits in the account are commensurate with the sanctioned limit and the nature and volume of business of the borrower. Any unusual items in the account should be carefully examined by the auditor. If the auditor's review indicates any unhealthy trends, the account should be further examined. The auditor's examination should also cover transactions in the post-balance sheet date period. Large transactions in major accounts particularly as at the year-end may be looked into to identify any irregularities in these accounts.
- (vii) Review periodic statements, cash flow statements, latest financial statements, etc. to assess the recoverability of advances.
- (viii) Verify whether the advance is secured and determine whether the security is legally enforceable, i.e., whether the necessary legal formalities regarding documentation, registration, etc., have been complied with; whether the security is in the effective control of the bank; and to what extent the value of the security, assessed realistically, covers the amount outstanding in the advance.
- (ix) Ensure that proper provisioning norms have been applied in view of non-

observance of terms, coupled with irregular payment of interest and default in repayment of instalments, if any.

**(2) Balances in Account of a Bank situated in a Foreign Country**

- (i) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.
  - (ii) Review the reconciliation statements and pay particular attention to the following.
    - (a) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.
    - (b) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.
    - (c) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.
  - (iii) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.
  - (iv) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.
  - (v) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS 11 on "The Effects of Changes in Foreign Exchange Rates".
- (b)** The items to be covered in the concurrent audit of advances of a bank are as follows:
- (i) Ensure that loans and advances are sanctioned properly.
  - (ii) Verify whether the sanctions are in accordance with the delegated authority.
  - (iii) Ensure that securities and documents have been received and properly charged/registered.
  - (iv) Ensure that post disbursement supervision and follow up is proper.
  - (v) Verify whether there is any misuse of loans and advances and whether there

are instances indicative of diversion of funds.

- (vi) Check whether letters of credit issued by the branch are within the delegated power and ensure that they are genuine trade transactions.
- (vii) Check bank guarantees issued are properly worked and recorded.
- (viii) Ensure proper follow up of overdue bills of exchange.
- (ix) Verify the classifications of advances are as per RBI directions.
- (x) Verify whether the submission of claims to DICGC and ECGC is in time.
- (xi) Verify the instances of exceeding delegated powers have been promptly reported.
- (xii) Verify the frequency and genuineness of such exercise of authority beyond to delegated powers of the concerned officials.

**12. Verification of Re-insurance outward :** The following steps may be taken by the auditor in the verification of re-insurance outward;

- (i) The auditor should verify that re-insurance underwriting returns received from the operating units regarding premium, claims paid, outstanding claims tally with the audited figures of premium, claims paid and outstanding claims.
- (ii) The auditor should check whether the pattern of re-insurance underwriting for outward cessions fits within the parameters and guidelines applicable to the relevant year.
- (iii) The auditor should also check whether the cessions have been made as per the stipulation applicable to various categories of risk.
- (iv) The auditor should verify whether the cessions have been made as per the agreements entered into with various companies.
- (v) It should also be seen whether the outward remittances to foreign re-insurers have been done as per the foreign exchange regulations.
- (vi) It should also be seen whether the commission on cession has been calculated as per the terms of the agreement with the re-insurers.
- (vii) The auditor should verify the computation of profit commission for various automatic treaty arrangements in the light of the periodical accounts rendered and in relation to outstanding loss pertaining to the treaty.
- (viii) The auditor should examine whether the cash loss recoveries have been claimed and accounted on a regular basis.
- (ix) The auditor should also verify whether the Claims Paid item appears in Outstanding Claims list by error. This can be verified at least in respect of major claims.
- (x) He should see whether provisioning for outstanding losses recoverable on cessions have been confirmed by the re-insurers and in the case of major claims, documentary support should be insisted and verified.

- (xi) Accounting aspects of the re-insurance cession premium, commission receivable, paid claims recovered, and outstanding losses recoverable on cessions have to be checked.
  - (xii) The auditor should check percentage pattern of gross to net premium, claims paid and outstanding claims to ensure comparative justification.
  - (xiii) The auditor should also check that the re-insurers balance on cessions and whether the sub ledger balances tallies with the general ledger balances.
  - (xiv) The auditor should review the individual accounts to find out whether any balance requires provisioning / write off or write back.
  - (xv) He should verify whether the balances with re-insurers are supported by necessary confirmation obtained from them.
  - (xvi) He should verify whether opening outstanding claims not paid during the year find place in the closing outstanding claims vis-a-vis the reinsurance inwards outstanding losses recoverable on cessions appears in both opening and closing list. If not, the reason for the same should be analysed.
  - (xvii) Any major event after the Balance Sheet date which might have wider impact with reference to subsequent changes regarding the claim recovery both paid and outstanding and also re-insurance balances will need to be brought out suitably.
13. **Functions of Cost Auditor:** The Institute of Cost and Works Accountants of India has detailed the principal functions of a cost auditor by way of comparison with the functions of the auditor of financial accounts. The principal functions of cost auditor, according to the aforesaid Institute are the following:
- (i) **Inventory**
    - (a) Is the size of the inventory adequate or excess compared with the production programme?
    - (b) Is the provision most economical?
    - (c) Does it ensure optimum order size?
    - (d) Does it take into account the storage cost on the one hand, and carrying cost on the other?
    - (e) Does it take note of lead time of the various items or groups of items?
    - (f) Does the receipt and issue system cause any bottle-neck in production?
    - (g) Does it involve too many forms and too much paper work?
    - (h) Is there any room for reduction of inventory cost consistent with production needs?
    - (i) Is the inventory as per the priced store ledger and as certified by the management physically correct?

- (j) Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?
  - (k) Does the issue of raw materials make the production in accordance with the standard or schedule or otherwise or covered by authorised schedule?
  - (i) Is the expenditure of consumable stores within the standard? If not, why not?
- (ii) Labour -**
- (a) Proper utilisation of labour and increase in productivity are now receiving attention, several productivity teams have emphasised importance of higher productivity. It is, therefore, essential to assess the performance efficiency of labour and compare it with standard performance, so that labour utilisation could be progressively improved. The labour force in Indian industries is generally very high compared to similar types of industries in other developed countries. Our aim should be to reach that level, though not immediately but over some time. A study of this nature would give an idea where the inefficiency lies so that timely and adequate steps could be taken to ensure maximum utilisation of labour to reduce labour cost.
  - (b) Cost of labour is allocated to different jobs with reference to time or job cards.
- (iii) Overheads and indirect expenditure -** The cost auditor will see and certify:
- (a) that allocation of indirect expenditure over production, sales, and distribution is logical and correct;
  - (b) that compared with the value of production in a production shop, overhead charges are not excessive;
  - (c) that actual indirect expenditure does not exceed budgets or standard expenditure significantly and that any variations are satisfactorily explained and accounted for;
  - (d) that the relation of indirect expenditure in keeping with the load on individual production shop is appropriate;
  - (e) correctness of appropriate allocation of overhead expenditure (both production and sales) will be certified by the cost auditor;
  - (f) that allocation of overheads between finished products and unfinished products is in accordance with correct principles.
- (iv) Work-in Progress -** The Cost Auditor will see the following:
- (a) that work-in-progress has been physically verified and that it agrees with the balance in the incomplete cost card;
  - (b) that valuation of the work-in-progress is correct with reference to stage of completion of each job or process and the value job cost cards or process cost sheet;

- (c) that there is no over-valuation or under-valuation of opening work-in-progress or closing work-in-progress, thereby artificially pushing up and down net profits or net assets as the case may be;
  - (d) that the volume and value of work-in-progress is not disproportionate compared with the finished out-turn.
14. (a) **Overdue interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.
- (b) **Compliance with provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.
- (c) **Special Report to the Registrar:** The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:
- (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
  - (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
  - (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
  - (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence

about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

15. (a) The provisions relating to tax audit under section 44AB of the Income Tax Act, 1961 applies to every person carrying on business, if his total sales, turnover or gross receipts in business exceed the prescribed limit of ₹ 1 crore (w.e.f. A.Y. 2013-14) and to a person carrying on a profession, if his gross receipts from profession exceed the prescribed limit of ₹ 25 lakhs (w.e.f. A.Y. 2013-14) in any previous year. However, the term "sales", "turnover" or "gross receipts" are not defined in the Act, and therefore the meaning of the aforesaid terms has to be considered for the applicability of the section.

Some of the merit consideration in this regard as discussed in the Guidance Note issued by the Institute are given below-

- (i) Discount allowed in the sales invoice will reduce the sale price and, therefore, the same can be deducted from the turnover.
- (ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. Therefore, should not be deducted from the turnover.
- (iii) Turnover discount is normally allowed to a customer if the sales made to him exceed a particular quantity. As per trade practice, it is in the nature of trade discount and should be deducted from the figure.
- (iv) Special rebate allowed to a customer can be deducted from the sales if it is in the nature of trade discount. If it is in the nature of commission on sales, the same cannot be deducted from the figure of turnover.
- (v) Price of goods returned should be deducted from the turnover even if the returns are from the sales made in the earlier year/s.
- (vi) Sale proceeds of any shares, securities, debentures, etc., held as investment will not form part of turnover. However if the shares, securities, debentures etc., are held as stock-in-trade, the sale proceeds thereof will form part of turnover.

In the given case, Concession Ltd. is engaged in manufacturing business. Therefore, the tax audit would be applicable if the turnover exceeds ₹ 1 crore during the financial year 2013-14. The calculation of effective turnover for the prescribed limit purpose, in accordance with abovementioned conditions, is given below:

Recorded turnover during the year	₹ 1,13,00,000
Less: (i) Discount allowed in the Sales Invoice	(₹ 8,20,000)
(ii) Trade discount	(₹ 2,90,000)
(iii) Sales Return	<u>(₹ 1,60,000)</u>
Effective turnover	<u>₹ 1,00,30,000</u>

The effective turnover of Concession Ltd. is Rupees one crore and thirty thousand only which is over and above the prescribed limit for tax audit under section 44AB of the Income tax Act, 1961. Thus, the provisions related to tax audit are applicable to the company and is therefore liable for tax audit.

- (b) Clause 18 of form 3CD, annexed to the tax audit report in Form 3CA/3CB, requires the tax auditor to specify particulars of payments made to person specified under section 40(A)(2)(b) of the Income Tax Act 1961. Persons specified in the said section are relatives of an assessee and sister concerns, etc. In the instant case, however, Mr. Verma has not made any payments to his brother. On the contrary, he must have received payments from him against exports made and, thus, this clause would be required to verify whether the exports are genuine, i.e. , whether the diamonds have been delivered by verifying the necessary delivery documents, relevant invoices, etc., the reasonableness of the price and whether the export realization have been received.

16. **NBFC Public Deposit Directions** - The auditors must ascertain whether the company is a loan company or an investment company or a hire purchase finance company or an equipment leasing company as per the classification, if any, assigned to the NBFC by the RBI. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results. Thereafter, it must be ascertained whether the company has complied with the following aspects in relation to the activity of mobilisation of public deposits.

- (i) The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. Obtain a copy of the credit rating assigned to NBFC and check whether the public deposits accepted/held by it are in accordance with the level of credit rating assigned to it.

In the event of a downgrading of credit rating, the auditor should bear in mind that the NBFC will have to reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame.

- (ii) Test checks the interest calculations in respect of public deposits mobilised by a NBFC to ascertain that the NBFC has not paid interest in excess as per specification. Likewise, test check the brokerage calculations with the bills and vouchers for reimbursement of out of pocket expenses submitted by a broker to ascertain that the NBFC has not paid brokerage in excess by way of reimbursement of expenses to brokers.
- (iii) Ascertain whether the NBFC has accepted or renewed any public deposit only after a written application form the depositor in the form to be supplied by the company, and shall contain all particulars specified in the Non-Banking Financial Companies and Miscellaneous Non Banking Companies (Advertisement) Rules, 1977. Further

ensure whether it contain the specific category of depositor, i.e., whether depositor is a shareholder or a director or a promoter or a member of public.

- (iv) Verify the deposit register maintained by a NBFC and test check the particulars that have been entered therein in respect of each depositor with supporting receipts issued to the depositors. Also check whether the NBFC is regularly paying its deposits on due dates and in the case of a delay/default, the reasons for the delay/default and the actual date of payment.
  - (v) Check whether the investments made in approved liquid assets by a NBFC holding public deposits have been lodged in safe custody with a designated scheduled commercial bank as required by the NBFC Public Deposit Directions. Obtain a certificate from the bank to that effect.
  - (vi) In the case of NBFCs accepting/holding public deposits ascertain whether audited statement of accounts together with a copy of the auditor's report and director's report thereon have been submitted within prescribed time limit from the date of holding the Annual general meeting.
  - (vii) Check whether the NBFC has filed its annual return as specified in the First Schedule before the 30<sup>th</sup> June with reference to its position as on the 31<sup>st</sup> March of each year.
  - (viii) In the case of NBFCs not accepting/holding public deposits, check whether a board resolution has been passed by the NBFC to the effect that it has neither accepted any public deposits nor would it accept any public deposits during the year.
  - (ix) In the case of Group Holding Investment Companies, check whether the NBFC has passed a board resolution to the effect that the company has invested or would invest/hold its investments in share and securities of group companies specifying the names of the companies. In addition to the above, group holding investment companies are required to give a further undertaking that it would not trade in such shares/securities and that it has neither accepted nor would it accept any public deposits during the year.
17. (a) **Applicability of Provisions of Internal Audit** : As per section 138 of the Companies Act, 2013, read with rule 13 of Companies (Audit and Auditors) Rules, 2014 every private company shall be required to appoint an internal auditor or a firm of internal auditors, having-
- (i) turnover of two hundred crore rupees or more during the preceding financial year; or
  - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year;

Thus, either of the condition is required to be satisfied for the applicability of the provision. The internal auditor to be appointed 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 auditor may or may not be an employee of the company.

Interior Pvt. Ltd. is having turnover of ₹ 210 crore and maximum outstanding loan from public financial institution of ₹ 90 crore during the previous financial year. Here in the case, the turnover is over and above two hundred crore rupees i.e. either of the condition in respect of turnover or outstanding loans is satisfied. Therefore the company is liable for internal audit as per section 138 of the Companies Act, 2013.

- (b) The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are:
- (i) **Organisational Status** - Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation he reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.
  - (ii) **Scope of Function** - The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.
  - (iii) **Technical Competence** - The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
  - (iv) **Due Professional Care** - The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.
18. A due diligence audit on behalf of C Ltd. with a view to acquiring the business shall involve following steps:
- (a) **Brief history of the target and background of its promoters** - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal

its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations

- (b) **Accounting policies** - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale. The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

- (c) **Review of Financial Statements** - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being the price of the target would be largely based upon its operating results. The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period.

- (d) **Taxation** - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. Generally taxes are levied both by the

Central Government as well as by the State Government. Further taxes may be direct or indirect. Most of the tax laws require the enterprise to register itself with the government and it is important to check if all necessary registrations have been made. The accountant has to also look at the tax effects of the merger or acquisition.

- (e) **Cash Flow** - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check if a) Is the company able to honour its commitments to its creditors, to the banks, to government and other stakeholders b) How well is the company able to turn its debtors and stocks c) How well does it deploy its funds d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?
- (f) **Financial Projections** - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the targets to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that the accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that as assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

- (g) **Management and Employees** - In the Indian context, the status of work force, staff and employees and their demands is a complex problem. In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of

the liability has to be obtained from a reputed actuary. The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

- (h) **Statutory Compliance** - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

In addition to the above steps, the following further points have to be seen:

- (i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.
- (ii) The length of the lease under which business has been operating.
- (iii) The unexpired period of patents if any held by the vendors.
- (iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/ compensation, etc.
- (v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.
- (vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.
- (vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.
- (viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

- 19 (a) As per clause 6 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he solicit clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

However, nothing herein contained shall be construed as preventing or prohibiting, any chartered accountant from applying or requesting for or inviting or securing professional work from another chartered accountants in practice.

In the instant case, CA N has written email to all the CA for securing professional work from them and has not approached any other person or professional or communicated with any client,

Thus as per exception to the clause 6, CA N is well within the regulation of the act and has not committed any professional misconduct.

- (b) As per clause 8 of Part I of First Schedule to the Chartered Accountants Act, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been Issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing.

This clause is applicable in situation of replacing of one auditor by another auditor. Internal auditor and statutory audition are parallel positions and not replacement positions. The management generally appoints the internal auditor whereas the statutory auditor will be appointed by the shareholders in the AGM. In this situation there is no need for communication by one to other.

In view of above the contention of the statutory auditor is unacceptable and there is no question of communicating in writing by Mr. T.

- (c) Clause 10 of Part I of Second Schedule states that a Chartered Accountant shall be deemed to be guilty of professional misconduct if "he fails to keep money of his clients in separate banking account or to use such money for the purpose for which they are intended."

Mr. Ram received the money on 15<sup>th</sup> December, 2013 which is to be paid to the client only on March 31, 2014. Hence, it should be deposited in a separate bank account.

Since in this case Mr. Ram have failed to keep the sum of ₹ 15 lakhs in a separate Bank Account and utilised the part money for personal purpose on birthday occasion. Therefore, it amounts to professional misconduct under clause 10 of part I of Second Schedule.

Connected case Law: *Mr. R. S. Murugai Vs. (1) S K Gadh & (2) V. K. Bajaj*

- (d) Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner

shall maintain and keep in respect of his/its professional practice, proper books of accounts including the following:

- (i) a Cash Book
- (ii) a Ledger

Thus, a Chartered Accountant in practice is required to maintain books of accounts. In the instant case, CA Smart does not maintain books of accounts and writes the fees received from various clients in small pocket diary. A small pocket diary maintained by him cannot be books of accounts.

Hence, Mr. Smart, being a practicing Chartered Accountant will be held guilty for professional misconduct for violation of Council General Guidelines, 2008.

20. (a) **Constitution of Audit Committee:** As per the section 177 of the Companies Act, 2013, every listed company and the following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

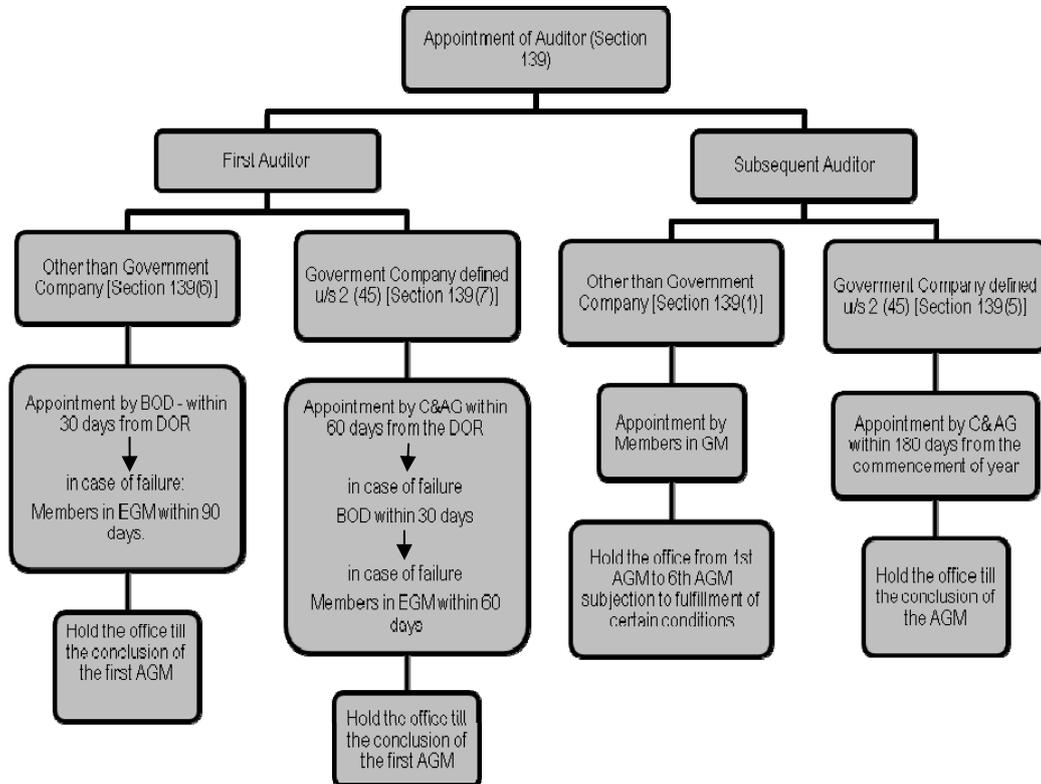
Explanation.- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

(b) **Areas Covered by Comprehensive Audit :** The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below:

- ◆ Comparison of overall capital cost of the project with the approved planned costs.

- ◆ Production or operational outputs vis-a-vis under-utilisation of the installed capacity.
  - ◆ Systems of project formulation and implementation.
  - ◆ Planned rate of return
  - ◆ Cost control measures.
  - ◆ Research and development programmes.
  - ◆ System of repairs and maintenance.
  - ◆ adequate purchase policies
  - ◆ Effective and economical procedures
  - ◆ Project planning
  - ◆ Undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources
- (c) **Sauda Book:** All members are required to maintain a 'Sauda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date wise. This register contains all the transactions, which may be of any of the kind mentioned below:
- (i) member's own business on the Exchange
  - (ii) member's business on the Exchange on behalf of clients
  - (iii) member's business with the clients on principal-to-principal basis
  - (iv) member's business with the members of other Stock Exchanges
  - (v) member's business on behalf of his clients with the members of other Stock Exchanges
  - (vi) Spot transactions, etc
- (d) **Appointment of Auditor:** Section 139 of the Companies Act, 2013 contains provisions regarding Appointment of Auditors. Discussion on appointment of auditors may be grouped under two broad headings-
- (i) Appointment of First Auditors.
  - (ii) Appointment of Subsequent Auditors.



(i) **Appointment of First Auditor**

- (1) **Appointment of First Auditor in the case of a company, other than a Government Company:** As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

- (2) **Appointment of First Auditor in the case of Government Company:** Section 139 (7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments,

the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

(ii) **Appointment of Subsequent Auditor/Reappointment of Auditor**

- (1) **Appointment of Subsequent Auditor in case of Non Government Company:** Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

- (i) The company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.
- (ii) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (iii) The certificate shall also indicate whether the auditor satisfies the criteria provided in section 141.
- (iv) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

- (2) **Appointment of Subsequent Auditor in case of Government Company:** As per Section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

- (e) **Collection of Evidence by Peer Reviewer:** A Peer Reviewer collects evidence by applying the following methods:
- (a) Inspection mainly consists of examination of documentation (working papers) and other records maintained by the practice unit.
  - (b) Observation consists of witnessing a procedure or process being performed by others. For example, while conducting on-site review, the reviewer may review the performance of internal control.
  - (c) Inquiry consists of seeking appropriate information from the partner (designated by the practice unit for the purpose)/sole proprietor or other knowledgeable persons within the practice unit. The inquiries may originate from the responses to the questions given in the questionnaire. The inquiries may also arise from the inspection of documentation maintained by the practice unit.

While observation and inquiry may be considered as external independent sources of review evidence, inspection remains the most significant method for confirming the effective observance of control procedures in the practice unit. Observation and inquiry may also corroborate the evidence provided by inspection. The reviewer, in order to carry out the review effectively, should have an understanding of the documentation maintained by the practice unit.

**III. Applicability of the Companies Act, 2013**

1. Accounting related sections of the Companies Act, 2013, notified in Sept, 2013, along with the clarifications issued by the Ministry of Corporate Affairs are applicable for Nov. 14 Examination.
2. Notified Sections of Chapter IX of the Companies Act, 2013 along with relevant Rules will be applicable for November, 2014 Examination.

**Paper 3: Advanced Auditing and Professional Ethics****I. Statements and Standards**

1. Statement on Reporting under Section 227(1A) of the Companies Act, 1956
2. Statement on the Companies (Auditor's Report) Order, 2003\*
3. Framework for Assurance Engagements.

**Note :** \*Statement on CARO, 2003 is applicable on Financial Statements prepared on or before March 31, 2014.

**II. Engagements and Quality Control Standards on Auditing**

<i>S.No</i>	<i>SA</i>	<i>Title of Standard on Auditing</i>
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
3	SA 210	Agreeing the Terms of Audit Engagements
4	SA 220	Quality Control for Audit of Financial Statements
5	SA 230	Audit Documentation
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements
7	SA 250	Consideration of Laws and Regulations in An Audit of Financial Statements
8	SA 260	Communication with Those Charged with Governance
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
10	SA 299	Responsibility of Joint Auditors
11	SA 300	Planning an Audit of Financial Statements
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

13	SA 320	Materiality in Planning and Performing an Audit
14	SA 330	The Auditor's Responses to Assessed Risks
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization
16	SA 450	Evaluation of Misstatements Identified during the Audits
17	SA 500	Audit Evidence
18	SA 501	Audit Evidence - Specific Considerations for Selected Items
19	SA 505	External Confirmations
20	SA 510	Initial Audit Engagements-Opening Balances
21	SA 520	Analytical Procedures
22	SA 530	Audit Sampling
23	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
24	SA 550	Related Parties
25	SA 560	Subsequent Events
26	SA 570	Going Concern
27	SA 580	Written Representations
28	SA 600	Using the Work of Another Auditor
29	SA 610	Using the Work of Internal Auditors
30	SA 620	Using the Work of an Auditor's Expert
31	SA 700	Forming an Opinion and Reporting on Financial Statements
32	SA 705	Modifications to the Opinion in the Independent Auditor's Report
33	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
34	SA 710	Comparative Information – Corresponding Figures and Comparative Financial Statements
35	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements
36	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework
37	SA 805	Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
38	SA 810	Engagements to Report on Summary Financial Statements

39	SRE 2400	Engagements to Review Financial Statements
40	SRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity
41	SAE 3400	The Examination of Prospective Financial Information
42	SAE 3402	Assurance Reports on Controls At a Service Organisation
43	SRS 4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information
44	SRS 4410	Engagements to Compile Financial Information

### III. Guidance Notes and other publications

1. Code of Ethics
2. Guidance Note on Independence of Auditors.
3. Guidance Note on Audit Reports and Certificates for Special Purposes.
4. Guidance Note on Audit under Section 44AB of the Income-tax Act.
5. Guidance Note on Audit of Abridged Financial Statements.
6. Guidance Note on Audit of Inventories.
7. Guidance Note on Audit of Debtors, Loans and Advances.
8. Guidance Note on Audit of Investments.
9. Guidance Note on Audit of Miscellaneous Expenditure.
10. Guidance Note on Audit of Cash and Bank Balances.
11. Guidance Note on Audit of Liabilities.
12. Guidance Note on Audit of Revenue.
13. Guidance Note on Audit of Expenses.
14. Guidance Note on Sections 227(3)(e) and (f) of the Companies Act, 1956.
15. Guidance Note on Certificate of Corporate Governance
16. Guidance Note on Computer Assisted Audit Techniques (CAATs).
17. Guidance Note on Audit of Payment of Dividend.
18. Guidance Note on Audit of Capital and Reserves.
19. Guidance Note on Auditing of Accounts of Liquidators.