

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any **five** from the rest

Question 1

- (a) As an auditor of RST Ltd. Mr. P applied the concept of materiality for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company's business, he wants to re-evaluate the materiality concept. Please, guide him. (5 Marks)
- (b) The financial statements of TC & Co. have been prepared by management of an entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework) to comply with provisions of the contract. Based on the contract, management does not have a choice of financial reporting frameworks. As an auditor what considerations would be undertaken while planning and performing audit? (5 Marks)
- (c) When a sub-service organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used. As a user auditor what information would you obtain about controls at a sub-service organization? (5 Marks)
- (d) In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow, when financial statements are audited for the first time. If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances', what approach you will adopt in drafting your audit report? (5 Marks)

Answer

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

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

The auditor shall revise materiality for the financial statements in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

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

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

- (b) Considerations for Planning and Performing Audit in case of Special Purpose Framework:** As per SA 800 “Special Considerations-Audits of Financial Statements Prepared in accordance with Special Purpose Frameworks”, financial statements prepared in accordance with a special purpose framework may be the only financial statements an entity prepares. In such circumstances, those financial statements may be used by users other than those for whom the financial reporting framework is designed.

While planning and performing audit of such special purpose framework based company, the auditor should consider below mentioned factors:

- (i) To obtain an understanding of the entity’s selection and application of accounting policies. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.
- (ii) Compliance of all SAs relevant to audit, the auditor may judge it necessary to depart from a relevant requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement.
- (iii) Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in SA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.
- (iv) In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with SA 320 for purposes of planning and performing the audit of the special purpose financial statements.

- (v) Communication with those charged with governance in accordance with SAs is based on the relationship between those charged with governance and the financial statements subject to audit, in particular, whether those charged with governance are responsible for overseeing the preparation of those financial statements. In the case of special purpose financial statements, those charged with governance may not have such a responsibility.
- (c) **Controls at a Sub-Service Organisation:** In accordance with SA 402 "Audit Considerations relating to an Entity Using a Service Organisation", a user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation.

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

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

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

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

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

If the Type 1 or Type 2 report excludes the control at a subservice organization and the services provided by the subservice organization are relevant to the audit of the user

entity's financial statements, the user auditor is required to apply the requirements of the SA 402 in respect of the subservice organization.

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

- (d) **Audit Procedure for ensuring correctness of Opening Balances:** As per SA 510 "Initial Audit Engagements-Opening Balances", the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by -
- (i) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
 - (ii) Determining whether the opening balances reflect the application of appropriate accounting policies; and
 - (iii) By evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or performing specific audit procedures to obtain evidence regarding the opening balances.

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

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

Question 2

- (a) *As an auditor of garment manufacturing company for the last five years you have observed that new venture of online shopping has been added by the company during current year. As an auditor what factors would be considered by you in formulating the audit strategy of the company?* (6 Marks)

- (b) *A Ltd. holds the ownership of 10% of voting power and control over the composition of Board of Directors of B Ltd. While planning the statutory audit of A Ltd., what factors would be considered by you for audit of financial statements?* (6 Marks)
- (c) *Write short note on-Corporate Responsibility under Sarbanes and Oxley Act.* (4 Marks)

Answer

- (a) **Formulation of Audit Strategy:** While formulating the audit strategy for a company, following factors may be considered -

General Factors:

- (i) The engagement objectives.
- (ii) The results of the business review, including major developments in the client's business and industry, significant operating results and financial arrangements.
- (iii) Preliminary judgements as to materiality.
- (iv) Identified inherent risks. The team should also consider the risk of fraud and, in particular, any evidence of a high level of risk to the firm. They should take into account the results of procedures for the acceptance and continuation of clients.
- (v) The degree to which the team should carry out further assessment of controls as a means of reducing substantive tests.
- (vi) The broad nature, extent and timing of substantive tests, or changes to the previous year's strategy for substantive testing.
- (vii) Main points relating to planning and controlling the audit or comments on the adequacy of the existing arrangements.

Specific Factors for Online Shopping:

The auditor shall also obtain an understanding of the information system, including the related business processes due to new venture of online shopping, including the following areas:

- (i) The classes of transactions in the entity's operations that are significant to the financial statements;
- (ii) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

- (iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- (v) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

- (b) **Voting Power and Control over the composition of Board of Directors:** In this case, A Ltd. holds only 10 percent of the voting power and control over the composition of the Board of Directors of B Ltd. In such a case, A Ltd. would be considered as a parent of B Ltd. and, therefore, it would consolidate B Ltd., in the consolidated financial statements as subsidiary.

The auditor should verify whether the parent controls the composition of the Board of Directors or corresponding governing body of any entity. There would be various means by which such kind of control can be obtained.

In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know how, enforcement of statute, as the case may be, etc.

The auditor should verify that the adjustments warranted by the relevant accounting standards have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. The auditor should make plans, among other things, for the understanding of accounting policies of the parent, subsidiaries, associates and joint ventures and determining and programming the nature, timing, and extent of the audit procedures to be performed etc.

Further, the duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity are considered as Related Party.

In forming an opinion on the financial statements the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework and whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or cause the financial statements to be misleading (for compliance frameworks).

- (c) **Corporate Responsibility under Sarbanes Oxley Act of 2002 :** The Sarbanes–Oxley Act of 2002, also known as the Public Company Accounting Reform and Investor Protection Act of 2002 is a United States federal law passed in response to a number of

major corporate and accounting scandals including those affecting Enron, Tyco International, and WorldCom. The act contains eleven titles and establishes corporate accountability and civil and criminal penalties for white – collar crimes. The title three deals with the Corporate Responsibility which is as follows:

- (i) The audit committee to be more independent through enhancement of their oversight responsibilities and one of the Audit committee members to be financial expert.
- (ii) Requires CEO & CFO to issue certification of the quarterly financial results and annual reports to SEC as part of compliance with Form 10K.
- (iii) Provides rules of conduct for companies managerial and their officers regarding Pension matters.
- (iv) To Comply with SEC rules requiring attorneys to report violation of securities to the company's CEO or Chief Legal Counsel and to Audit Committee if no action is taken.

Question 3

- (a) *MG & Co. Ltd. seeks your advice while preparing financial statements the general instructional to be followed while preparing Balance Sheet under Companies Act, 2013 in respect of current assets and liabilities. (4 Marks)*
- (b) *C.A. Ashwin was appointed as auditor of Bristol Ltd. for the year 2013-14. Since he declined to accept the appointment, the Board of Directors appointed C.A. John as the Auditor in place of C.A. Ashwin and the appointment was accepted by C.A. John. Discuss. (4 Marks)*
- (c) *During the bank audit AB & Co. a new Chartered Accountant firm, observed the sale/purchase of NPAs. Please help them by narrating the aspects, relating to sale/purchase of NPAs, to be considered. (4 Marks)*
- (d) *Draft an audit report under following circumstances:*
 - (i) *Under the Payment of Bonus Act, 1965, a 'report' on the computation of bonus payable.*
 - (ii) *Auditor's Report in accordance with Regulation 54 of the SEBI (Mutual Fund) Regulation, 1993. (4 Marks)*

Answer

- (a) **General Instructions for Preparation of Balance Sheet:**
 - (i) **General Instruction in respect of Current Assets:** An asset shall be classified as current when it satisfies any of the following criteria-
 - (1) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

- (2) it is held primarily for the purpose of being traded;
- (3) it is expected to be realized within twelve months after the reporting date; or
- (4) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

(ii) **General Instruction in respect of Current Liabilities:** A liability shall be classified as current when it satisfies any of the following criteria-

- (1) it is expected to be settled in the company's normal operating cycle;
- (2) it is held primarily for the purpose of being traded;
- (3) it is due to be settled within twelve months after the reporting date; or
- (4) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

(b) **Accepting Appointment Without First Ascertaining Compliance of Relevant Sections of the Companies Act:** As per section 139(8)(i) and section 139(6) of the Companies Act, 2013, board can appoint the auditor in the case of casual vacancy. Further, as per section 139(10) when at any annual general meeting no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

In view of the provisions given in Section 139, non-acceptance of appointment by C.A. Ashwin does not constitute a casual vacancy; therefore it should not be filled by the Board. Thus, the appointment of the auditor by the Board is defective in law.

Clause (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949 provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with Section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

Conclusion:

In the instant case-

- (i) CA Ashwin was appointed as an auditor of Bristol Ltd., however he declined to accept the appointment. Resulting to such decline, the board appointed CA. John as an auditor and such appointment was accepted by him.
- (ii) Accordingly, C.A. John is guilty of professional misconduct as per Clause (9) of Part I of the First Schedule, as he accepted the appointment without verification of statutory requirements.

(c) Sale/Purchase of Non Performing Assets: Aspects to be considered relating to purchase/sale of Non-Performing Assets are -

- (i) A non-performing asset in the books of a bank is eligible for sale to other banks only if it has remained a nonperforming asset for at least two years in the books of the selling bank.
- (ii) Any purchase/sale of non-performing financial assets should be conducted in accordance with the policy approved by the Board.
- (iii) NPAs can be sold to other banks only on cash basis.
- (iv) The entire sale consideration should be received upfront and the asset can be taken out of the books of the selling bank only on receipt of the entire sale consideration.
- (v) A non-performing financial asset should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks. Banks should not sell such assets back to the bank, which had sold the NPFA.
- (vi) Banks should, while selling NPAs, work out the net present value of the estimated cash flows associated with the realisable value of the available securities net of the cost of realisation. The sale price should generally not be lower than the net present value so arrived.
- (vii) The estimated cash flows are normally expected to be realised within a period of three years.
- (viii) Banks are also permitted to sell/buy homogeneous pool within retail non-performing financial assets, on a portfolio basis provided each of the non-performing financial assets of the pool has remained as non-performing financial asset for at least 2 years in the books of the selling bank. The pool of assets would be treated as a single asset in the books of the purchasing bank.
- (ix) The selling bank should pursue the staff accountability aspects as per the existing instructions in respect of the non-performing assets sold to other banks.
- (x) A bank may purchase/sell non-performing financial assets from/to other banks only on 'without recourse' basis, i.e., the entire credit risk associated with the non-performing financial assets should be transferred to the purchasing bank.

The selling bank should ensure that the effect of the sale of the financial assets should be that the asset is taken off its books and after the sale there should not be any known liability devolving on the selling bank.
- (xi) Banks should ensure that subsequent to sale of the non-performing financial assets to other banks, they do not have any involvement with reference to assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Consequently, the specific financial asset should not enjoy the support of credit enhancements / liquidity facilities in any form or manner.

- (xii) Each bank should make its own assessment of the value offered by the purchasing bank for the financial asset and decide whether to accept or reject the offer.
- (xiii) Under no circumstances can a sale to other banks be made at a contingent price whereby in the event of shortfall in the realisation by the purchasing banks, the selling banks would have to bear a part of the shortfall.
- (xiv) Prudential norms for banks for the purchase/sale transactions issued by RBI, from time to time, should be adhered to.

(d) Draft Audit Report:

(i) Under the Payment of Bonus Act, 1965, a 'report' on the computation of bonus payable -

"We have reviewed the figures in the above computation in comparison with the books and records produced to us, the audit of which has already been completed by us and report that subject to the notes given on face of the computation in our opinion, and to the best of our knowledge and belief and according to the information and explanation given to us, the above computation is in due accordance therewith and has been made on a basis reasonably consistent with the provisions of the Payment of Bonus Act, 1965."

Place: For X & Co.

Date: Chartered Accountants

(ii) Auditor's Report in accordance with Regulation 54 of the SEBI (Mutual Fund) Regulations, 1993 -

- (1) The auditor shall state whether:
 - (a) He has obtained all information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit.
 - (b) The Balance Sheet and the Revenue Account are in agreement with the books of account of the fund.
- (2) The auditor shall give his opinion as to whether:
 - (a) The Balance Sheet gives a true and fair view of the scheme wise state of affairs' of the fund as at the balance sheet date, and
 - (b) The Revenue Account gives a true and fair view of the scheme wise surplus/deficit of the fund for the year/period ended at the balance sheet date.

Question 4

- (a) *R and M is an audit firm having partners CA R, CA M and CA G. Mr. S is the relative of CA R holding shares of STP Ltd. having a face value of ` 1,51,000. Whether CA R and*

- CA M are qualified to be appointed as auditors of STP Co? (4 Marks)
- (b) As an auditor, during your interim visit at Marathon Ltd. you observed that internal controls were not in use throughout the period covered under audit. What are the controls objectives you would like to consider to achieve your purpose? (6 Marks)
- (c) Parent Ltd. acquired 51% shares of Child Ltd. during the year ending 31-3-2014. During the financial year 2014-15 the 20% shares of Child Ltd. were sold by Parent Ltd. Parent Ltd. while preparing the financial statements for the year ending 31-3-2014 and 31-3-2015 did not consider the financial statements of Child Ltd. for consolidation. As a statutory auditor how would you deal with it? (6 Marks)

Answer

- (a) **Holding of Shares by Relative of Partner:** As per section 141(3)(d)(i) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. Further as per proviso to this Section, the relative of the auditor may hold the securities or interest in the company of face value not exceeding of ` 1,00,000.

In the instant case, R and M is an audit firm having partners CA R, CA M and CA G. Mr. S is a relative of CA R and he is holding shares of STP Ltd. of face value of ` 1,51,000.

Therefore, R and M, audit firm along with its partners, CA R, CA M and CA G, will be disqualified for appointment as an auditor, as the relative of CA R is holding the securities in STP Ltd which is exceeding the limit mentioned in proviso to section 141(3)(d)(i).

Thus, CA R and CA M, will be disqualified to be appointed as auditors of STP Ltd. The answer has been given assuming that both STP Ltd. and STP Co. are same.

- (b) **Control Objectives to be considered for Audit Purpose:** The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. Thus, the auditor should consider whether the internal control were in use throughout the period or not. In the absence of the same, the auditor should consider the following control objectives for to achieve the purpose:
- (i) Policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business.
 - (ii) Adherence to company's policies.
 - (iii) Safeguarding of its assets.
 - (iv) Prevention and detection of frauds and errors.

- (v) Accuracy and completeness of the accounting records.
 - (vi) Timely preparation of reliable financial information.
 - (vii) Reliability of entity's financial reporting.
 - (viii) Compliance with applicable laws and regulations.
 - (ix) Effectiveness and efficiency of its operation.
 - (x) Assets are verified at reasonable intervals and appropriate action is taken with regard to the discrepancies.
 - (xi) Proper authorization of transactions.
 - (xii) Risk assessment procedures.
 - (xiii) Monitoring of accounting/financial controls.
 - (xiv) Changes occurred in the accounting and internal control systems during the period.
 - (xv) Nature, timing and extent of substantive procedures which the auditor plans to carry out.
 - (xvi) Nature and amount of the transactions and other events and the balance involved.
 - (xvii) Supervisory and Physical controls.
 - (xviii) Reviews of performance.
 - (xix) Systematic information processing.
 - (xx) Ensure segregation of duties.
- (c) **Consolidation of Financial Statement of a Subsidiary:** Accounting Standard 21 "Consolidated Financial Statements", states that a subsidiary should be excluded from consolidation when control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future .

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are acquired & held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be accounted for in accordance with AS 13 "Accounting for Investments".

In the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary is temporary, the auditor should verify that the intention of the parent, to dispose the subsidiary, in the near future, existed at the time of acquisition of the subsidiary. The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements.

However, as per section 129(3) of the Companies Act, 2013 where a company having subsidiary, which is not required to prepare consolidated financial statements under the

Accounting Standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In the given case, Parent Ltd. has acquired 51% shares of Child Ltd. during the year ending 31.03.2014 and sold 20% shares during the year 2014-15. Parent Ltd. did not consolidate the financial statements of Child Ltd. for the year ending 31.03.2014 and 31.03.2015.

The intention of Parent Ltd. is quite clear that the control in Child Ltd. is temporary as the former company disposed off the acquired shares in the next year of its purchase. However, for the compliance of provisions related to consolidation of financial statements given under section 129(3) of the Companies Act, 2013 Parent Ltd. is required to consolidate the financial statements as per the provisions on consolidated financial statements provided in Schedule III to the Act.

Question 5

Comment with respect to Chartered Accountant Act 1949:

- (a) *Mr. SP, a Chartered Accountant, obtains registration as category IV Merchant Banker under the SEBI's Rules and Regulations and act as Advisor to a capital issue of MB Co. Ltd. He designates himself under the caption "Merchant Banker" in client offer documents and 'Advisor to issue' in his own letterheads, visiting cards and professional documents. (4 Marks)*
- (b) *A Chartered Accountant having CoP entered into partnership with persons, who are not the members of the institute, for the purpose of carrying on business. The share of the chartered account in the profit and losses was 25%. He was to take part in the business and was entitled to represent the firm before Govt. authorities etc. He was operating the bank account of the firm, was receiving moneys from the customers and was also looking after the affairs of the Partnership. (4 Marks)*
- (c) *CA SG a practicing CA agreed to select and recruit personnel, conduct training program for and on behalf of the client. (4 Marks)*
- (d) *Mr. P a practicing chartered accountant acting as liquidator of AB & Co. charged his professional fees on percentage of the realization of assets. (4 Marks)*

Answer

- (a) **Use of Designation other than Chartered Accountant:** Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949 restrains a Chartered Accountant in practice from advertising his professional attainments or services. It also prohibits a member from using any designation or expressions other than the Chartered Accountant on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a University established by law in India or recognized by the Central Government or a title indicating membership of the Institute of Chartered Accountants or

of any other institution that has been recognized by the Central Government or may be recognized by the Council.

It may be noted that, in Client Companies' offer documents and advertisements regarding capital issue, name and address of the Chartered Accountant acting as Advisor or Consultant to the Issue could be indicated under the caption "Advisor/ Consultant to the Issue". Further, such members should not use the designation of either 'Merchant Banker' or 'Advisor/Consultant to Issue' in their own letterheads, visiting cards, professional documents, etc.

In the given case, Mr. SP, a Chartered Accountant, has obtained registration as category IV Merchant banker and acted as advisor to a capital issue of MB Co. Ltd. He has designated himself under the caption "Merchant Banker" in client offer documents and "advisor to issue" in his own letterheads, visiting cards and professional documents.

Therefore, Mr. SP shall be held guilty of professional misconduct as per Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949.

- (b) Practicing CA Entering into Partnership and Carrying on Business:** As per Clause (4) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he enters into partnership, in or outside India, with any person other than Chartered Accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of section 4 or whose qualifications are recognized by the Central Government or the Council for the purpose of permitting such partnerships.

It may be noted that the Council has prescribed the list of person qualified and the professional bodies for the purpose of entering into partnership under the Chartered Accountants Regulations, 1988.

Further, according to Clause (11) of Part I of First Schedule to the said Act, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

It may also be noted that a member in practice is required to apply for specific and prior approval of the Council for entering into any business.

In the given case, a chartered accountant in practice has entered into partnership with persons who were not the members of the Institute, for the purpose of carrying on business.

The question is silent about with whom the partnership has been entered into and whether the prior permission for entering into such business has been obtained.

Conclusion:

It is assumed that the persons with whom the partnership has been entered into has not been allowed under the Regulations and the prior approval of the Council has not been obtained for entering into such business. Hence, the Chartered Accountant shall be held guilty of professional misconduct under Clause (4) and Clause (11).

- (c) **Practicing CA Providing Personnel Recruitment and Selection Services:** Under Section 2(2)(iv) of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed "to be in practice" when individually or in partnership with Chartered Accountants in practice, he, in consideration of remuneration received or to be received renders such other services as, in the opinion of the Council, are or may be rendered by a Chartered Accountant in practice.

Pursuant to Section 2(2)(iv) above, the Council has passed a resolution permitting a Chartered Accountant in practice to render entire range of "Management Consultancy and other Services".

The definition of the expression "Management Consultancy and other Services" includes Personnel recruitment and selection. Personnel recruitment and selection includes, development of human resources including designing and conduct of training programmes, work study, job description, job evaluation and evaluations of workloads.

In the given case, CA SG, a practicing Chartered Accountant, has agreed to select and recruit personnel, conduct training program for and on behalf of a client, which is within the meaning of Management Consultancy and other Services.

In view of above facts and circumstances, CA SG is not guilty of professional misconduct.

- (d) **Chartered Accountant in Practice Acting as Liquidator:** According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, CA Regulation allow the Chartered Accountant in practice to charge the fees, in respect of any professional work, which are based on a percentage of profits, or which are contingent upon the findings or results of such work, in the case of a receiver or a liquidator, and the fees may be based on a percentage of the realization or disbursement of the assets.

In the given case, Mr. P, a practicing Chartered Accountant, has been acting as liquidator of AB & Co. and charged his professional fees on percentage of the realisation of assets.

Therefore, Mr. P shall not be held guilty of professional misconduct as he is allowed to charge fees on percentage of the realisation of assets, being a liquidator.

Question 6

- (a) *The auditor report of company states that proper books of accounts as required by law have been maintained by the company. What is the role of statutory auditor of the company, when a company be said to have not maintained proper books of account?* (4 Marks)
- (b) *Comment with respect to computation of total sales, turnover or gross receipts in business exceeding the prescribed limit under Section 44 AB of Income Tax Act, 1961 and VAT law.* (4 Marks)
- (i) *Discount allowed in the sales invoice*
- (ii) *Cash discount*
- (iii) *Price of goods returned related to earlier year*
- (iv) *Sale proceeds of fixed assets.*
- (c) *Explain the stepwise approach adopted by the Peer reviewer.* (4 Marks)
- (d) *AB Pvt. Ltd. company having outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint internal auditor. Please guide him who can be appointed as internal auditor and what would be reviewed by him.* (4 Marks)

Answer

- (a) **Proper Books of Account Not Maintained:** As per Section 128 of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting.

The provisions mentioned above are required to be followed by the company to maintain proper books of accounts. The Auditor is required to check that the company has complied with all the provisions related to maintenance of books of accounts etc.

Further, the books have to be maintained under accrual system and if the statutory auditor finds the books are not maintained accordingly, he will have to modify his report.

In addition, according to Section 143(3)(b), the auditor's report shall also state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.

If answer is in negative or with qualification, the report shall state the reasons for the same.

(b) Computation of Sales, Turnover or Gross Receipts:

I. In the context of section 44AB of the Income Tax Act, 1961: Following considerations are required with regard to computation of sales, turnover or gross receipts in business exceeding the prescribed limit under section 44AB of the Income Tax Act, 1961-

- (i) Discount allowed in the sales invoice will reduce the sale price and, therefore, the same can be deducted from the turnover.
- (ii) Cash discount otherwise than that allowed in a cash memo/sales invoice is in the nature of a financing charge and is not related to turnover. Therefore, should not be deducted from the turnover.
- (iii) Price of goods returned should be deducted from the turnover even if the returns are from the sales made in the earlier year/s.
- (iv) Sale proceeds of fixed assets would not form part of turnover since these are not held for resale.

II. In the context of VAT Law: Following considerations are required with regard to computation of sales or turnover in business exceeding the prescribed limit as per VAT Law-

- (i) Discount allowed in the sales invoice should be deducted from the sales or turnover.
- (ii) Cash discount should not be deducted from the sales or turnover.
- (iii) Price of goods returned is to be deducted only if they are made within the prescribed time.
- (iv) Sale proceeds of a fixed asset will form a part of turnover or sales for the purpose of VAT law.

(c) Approach of the Reviewer: The stepwise approach which may be adopted by the reviewer is discussed below-

- (i) The reviewer should gain an understanding of the engagement letter since an assurance engagement or for that matter any other kind of engagement should begin with an engagement letter. This understanding would help him in planning the review of documentation.
- (ii) The number of assurance engagements to be selected requires the exercise of judgement by the reviewer based on the evaluation of replies given in the questionnaire and the size of the practice unit.
- (iii) The practice unit may have policies and procedures for accepting a particular engagement. The reviewer should, wherever possible, examine that the policies and procedures for acceptance of audit have been complied with and necessary documentation with regard to the same exists.

- (iv) The reviewer may follow a combination of compliance procedures and substantive procedures throughout the peer review process.
- (v) Finally, the reviewer while evaluating records may consider the following:
- ❖ determine that any significant issues, matters, problems that arose during the course of the engagement have been appropriately considered, resolved and documented;
 - ❖ determine that adequate audit evidence or other relevant evidence in relation to the engagement is obtained to support the reasonableness of the conclusions drawn; and
 - ❖ determine that significant decisions relating to the engagement, use of professional judgement, resolution of significant matters have been properly documented.
- (d) **Applicability of Internal Audit:** Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if its outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In view of above provisions, AB Pvt. Ltd. is under compulsion to conduct internal audit, as its loans or borrowings are falling under the prescribed limit.

Who can be appointed as Internal Auditor- The internal auditor shall either be a chartered accountant, whether engaged in practice or not, or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies.

The internal auditor may or may not be an employee of the company.

Work to be reviewed by Internal Auditor- Each of the managerial functions should constantly be viewed by the internal auditor. The scope of internal auditor's work should include a review of:

- (i) internal control system and procedures.
- (ii) system regarding the custodianship and safeguarding of assets - monetary and non-monetary of enterprise.
- (iii) compliance by the various segments with the policies, plans and procedures of the enterprise as well as with the relevant regulations and laws.
- (iv) system of collecting data both monetary and non-monetary - to ensure that the information given to management and to external agencies is relevant and reliable.
- (v) organisational structure of the enterprise and its congruence with its objectives.
- (vi) efficient and economical use of available resources tangible as well as intangible.
- (vii) various operations.

Question 7

Write short notes/comments on four of the following:

- (a) Core Investment Companies. (4 Marks)
- (b) Investible funds as defined by IRDA (4 Marks)
- (c) Areas in which due diligence can take place. (4 Marks)
- (d) Operational auditing arose from the need of managers responsible for areas beyond their direct supervision. (4 Marks)
- (e) "Review of the internal audit function has become statutory responsibility for the statutory auditor". (4 Marks)

Answer

(a) Core Investment Company: These are NBFCs which carry on the business of acquisition of shares and securities in group companies and satisfies four conditions stated in the regulatory framework for Core Investment Companies issued by RBI, namely-

- (i) it holds not less than 90% of its Total Assets in the form of investment in equity shares, preference shares, debt or loans in group companies;
- (ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its Total Assets;
- (iii) it does not trade in its investments in shares, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;
- (iv) it does not carry on any other financial activity referred to in section 45-I(c) and 45-I(f) of the RBI Act, 1934 except investment in bank deposits, money market instruments, government securities, loans and investments in debt issuances of group companies or guarantees issued on behalf of group companies.

(b) Investible Funds: Insurance Companies make Investments, apart from earning income, to comply with the relevant statutory requirements and also for meeting any unforeseen contingencies and claims. The regulations issued by the authority from time to time affect the quantum of investments, the nature of assets in which investments are to be made.

As per the IRDA (Investments) Regulation, the investible funds have to be invested as per prescribed guidelines. For example –

- (i) Some of the investible funds as provided under Regulation are Central Government Securities; State Government Securities or other approved securities;
- (ii) Approved investments as specified in Section 27B of the Act and other Investment as specified in section 27B(3) of the Act and schedule II to the Regulations, subject to exposure norms as specified in Regulation 9;

- (iii) Other investments as specified under Section 27B(3) of the Act, subject to Exposure/ Prudential Norms as specified in Regulation 9; housing and loans to State Government for Housing and Fire Fighting equipment, by way of subscription or purchase of investment in housing, infrastructure, etc.

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

- (i) **Commercial / operational due diligence:** It is generally performed by the concerned acquire enterprise involving an evaluation from commercial, strategic and operational perspectives. For example, whether proposed merger would create operational synergies.
 - (ii) **Financial Due Diligence:** It involves analysis of the books of accounts and other information pertaining to financial matters of the entity. It should be performed after completion of commercial due diligence.
 - (iii) **Tax Due diligence:** It is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. The accountant has to look at the tax effect of the merger or acquisition.
 - (iv) **Information systems due diligence:** It pertains to all computer systems and related matter of the entity.
 - (v) **Legal due diligence:** This may be required where legal aspects of functioning of the entity are reviewed. For example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws.
 - (vi) **Environmental due diligence:** It is carried out in order to study the entity's environment, its flexibility and adaptiveness to the acquirer entity.
 - (vii) **Personnel due diligence:** It is carried out to ascertain that the entity's personnel policies are in line or can be changed to suit the requirements of the restructuring.
- (d) Need of Operational Audit:** The need for operational auditing has arisen due to the inadequacy of traditional sources of information for an effective management of the company where the management is at a distance from actual operations due to layers of delegation of responsibility, separating it from actualities in the organisation. Specifically, operational auditing arose from the need of managers responsible for areas beyond their direct observation to be fully, objectively and currently informed about conditions in the units under control.

Operational audit is considered as a specialised management information tool to fill the void that conventional information sources fail to fill. Conventional sources of management information are departmental managers, routine performance report, internal audit reports, and periodic special investigation and survey. These conventional sources fail to provide information for the best direction of the departments all of whose activities do not come under direct observation of managers.

- (e) **Review of Internal Audit Function:** 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. He should review the internal auditor's work, taking into account the following factors -
- (i) The scope of work and related audit programme are adequate for the external auditor's purpose.
 - (ii) The work is properly planned and the work of assistants is properly supervised, reviewed, and documented.
 - (iii) Sufficient appropriate evidence is obtained to afford a reasonable basis for conclusions reached.
 - (iv) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.
 - (v) Any exceptions or unusual matters are disclosed by the internal auditor's procedures. The external auditor should document his conclusions in respect of the specific work which he has reviewed.

The external auditor should also test the work of the internal auditor on which he intends to rely. The nature, timing and extent of the external auditor's tests will depend upon his judgement as to the materiality of the area concerned to the financial statements taken as a whole and the results of his evaluation of the internal audit function and of the specific internal audit work. His tests may include examination of items already examined by the internal auditor, examination of other similar items, and observation of the internal auditor's procedure.

Finally, in India even the statute has now recognised that internal audit is necessary for efficient running of companies. Thus a review of the internal audit function in specified companies has become a statutory responsibility for the statutory auditor.