

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any five from the rest

Question 1

- (a) *Mr. Z who is appointed as auditor of Elite Co. Ltd. wants to use confirmation request as audit evidence during the course of audit. What are the factors to be considered by Mr. Z when designing a confirmation request? Also state the effects of using positive external confirmation request by Mr. Z. (5 Marks)*
- (b) *R & M Co. wants to be alert on the possibility of non-compliance with Laws and Regulations during the course of audit of SRS Ltd. R & M Co. seeks your guidance for identifying the indications of non compliance with Laws and Regulations. (5 Marks)*
- (c) *The management of CSITA Ltd. has prepared its summary financial statements for the year 2015-16 to be provided to its investors. Consequently the company wants to appoint you for conducting audit of summary financial statements. What are the procedures that you will perform and consider necessary as the basis for forming an opinion on the summary financial statements? (5 Marks)*
- (d) *The financial statements of Ace Ltd. have been prepared by the management in accordance with special purpose frame work to meet the financial reporting provisions of a regulator. As an auditor, what considerations would be undertaken while planning and performing an audit in case of such special purpose frame work? (5 Marks)*

Answer

- (a) **As per SA 505, "External Confirmation", factors to be considered when designing confirmation requests include:**
- (i) The assertions being addressed.
 - (ii) Specific identified risks of material misstatement, including fraud risks.
 - (iii) The layout and presentation of the confirmation request.
 - (iv) Prior experience on the audit or similar engagements.
 - (v) The method of communication (for example, in paper form, or by electronic or other medium).
 - (vi) Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
 - (vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

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

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

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

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

- (c) As per SA 810, “Engagement to Report on Summary Financial Statements”, the auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor’s opinion on the summary financial statements:
- (i) Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.
 - (ii) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
 - (1) From whom or where the audited financial statements are available; or
 - (2) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
 - (iii) Evaluate whether the summary financial statements adequately disclose the applied criteria.
 - (iv) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be re-calculated from the related information in the audited financial statements.
 - (v) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.
 - (vi) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
 - (vii) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.
- (d) **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.

Question 2

- (a) *ENP Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As an auditor of ENP Ltd., you would like to use the report of the actuary as an audit evidence. How would you evaluate the work of the actuary? (4 Marks)*
- (b) *KSY & Co. Chartered Accountants is an audit firm having two partners CA K and CA Y. KSY & Co. is already holding appointment as auditors of 36 public companies.*

KSY & Co. seeks your advice in the following situations:

- (i) *KSY & Co. has been offered the appointment as Auditors of 7 more Private Limited Companies. Of the seven, one is a company with a paid up share capital of*

₹ 150 crores, five are "Small companies" as per the Act and one is a "Dormant Company".

- (ii) Would your answer be different, if out of those 7 Private Companies, 3 Companies have paid up capital of ₹ 90 crores each? (4 Marks)
- (c) What are the General Steps in the conduct of Risk based audit? (4 Marks)
- (d) State the key requirements of auditing standards of Public Company Accounting over sight board. (4 Marks)

Answer

- (a) **Evaluating the Work of Management's Expert:** As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes, -

- (i) Evaluate the competence, capabilities and objectivity of that expert;
- (ii) Obtain an understanding of the work of that expert; and
- (iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

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

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

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

- (i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
 - (ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
 - (iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.
- (b) **Ceiling Limit for Holding Company Audits:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time

employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than 100 crore.

In the instant case, KSY & Co. is an audit firm having two partners, namely, CA. K and CA. Y. The total number of company audits that can be accepted by the firm is 40 (2 partners x 20 companies each partner). However, the firm is already holding appointment as auditors of 36 public companies. Thus, the remaining number of audits that can be accepted by the firm is of 4 more companies.

- (i) In the given situation, KSY & Co. has been offered appointment as auditors of 7 private limited companies out of which 1 is a private limited company with paid-up share capital of ₹ 150 crores, 5 are 'small companies' and 1 is 'dormant company'.

In view of above discussed provisions and explanations, KSY & Co. can hold appointment as an auditor in 5 'small companies' and 1 'dormant company' as these are excluded from the ceiling limit of company audits.

In addition, the firm can also accept appointment as auditor of 1 private limited company with paid-up share capital of ₹ 150 crores which will be within the maximum ceiling limit of 40 company audits.

Therefore, KSY & Co. can accept appointment for all the 7 private limited companies as asked in question.

- (ii) No, answer will not be different in the given situation, where KSY & Co. has been offered appointment as auditors of 7 private limited companies out of which 3 companies have paid-up share capital of ₹ 90 crores.

In view of above discussed provisions and explanations, KSY & Co. can hold appointment as an auditor in all the private companies as 3 private companies are having paid-up share capital of ₹ 90 crores which are exempted as per the provisions of the Companies Act, 2013, therefore, excluded from the ceiling limit of company audits and other 4 private companies will also be within the maximum ceiling limit of 40 company audits even if the paid-up share capital is ₹ 100 crore or more.

[Note: The answer has been given assuming none of the partners hold any company audits in their personal capacity or as partners with another firm.]

- (c) **General Steps in the Conduct of Risk Based Audit (RBA):** RBA consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:

- (i) **Understand auditee operations to identify and prioritize risks** - Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements.
 - (ii) **Assess auditee management strategies and controls to determine residual audit risk** - Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.
 - (iii) **Manage residual risk to reduce it to acceptable level** - Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.
 - (iv) **Inform auditee of audit results through appropriate report** - The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.
- (d) **Auditing Standards of the Public Company Accounting Oversight Board (PCAOB) has the following key requirements:**
- (i) The design of controls-relevant assertions related to all significant accounts and disclosures in the financial statements;
 - (ii) Information about how significant transactions are initiated, authorized, supported, processed, and reported;
 - (iii) Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur;
 - (iv) Controls designed to prevent or detect fraud, including who performs the controls and the regulated segregation of duties;
 - (v) Controls over the period-end financial reporting process;

- (vi) Controls over safeguarding of assets;
- (vii) The results of management's testing and evaluation.

Question 3

(a) *KG Ltd. wants to provide prospective Financial Information to its investors with information about future expectations of the company. You are engaged by KG Ltd. to examine the Projected Financial Information and give report thereon. What will you consider in assessing the presentation and disclosure of the prospective Financial Information and the underlying assumptions?* (4 Marks)

(b) *M/s IO Ltd. is registered with Registrar of Companies on 1st of May 2014. The Company's 27% of paid up share capital is held by Central Government; 28% by State Government and the remaining 45% by public. The Board of Directors appointed RMG, Chartered Accountants as statutory auditors for the financial year 2014-15 by passing a resolution at the Board Meeting held on 25th May, 2014.*

Comment whether appointment is valid or not. (4 Marks)

(c) *M/s ME Ltd. is a manufacturing company of M/s Bars and Rods. The turnover of the company for financial year 2014-15 was ₹ 870 crores. The audit committee has appointed M/s MK Associates, Chartered Accountants as an internal auditor of the company for the financial year 2015-16. As an auditor of ME Ltd., draw out the internal audit plan specifying the coverage of area.* (4 Marks)

(d) *The Board of Directors of ACP Ltd. has recommended the dividend of 15% on paid up share capital of ₹ 450 crore for the year ended 31st March, 2015, at their meeting held on 1st of May, 2015 when the accounts for the financial year 2014-15 were approved. The Board of Directors when they met on 7th July, 2015 for the review of first quarter accounts, they realized that results were negative for the first quarter. Therefore, the Board has decided to rescind their decision to recommend dividend.*

The notice for AGM to be held on 14.8.2015 was sent on 15th July, 2015 without any recommendation for dividend.

At the AGM, the members asked the management how they can rescind the declaration of dividend once recommended. Comment. (4 Marks)

Answer

(a) **Consideration for Assessing Presentation and Disclosure of Prospective Financial Information and Underlying Assumptions:** As per SAE 3400 "The Examination of Prospective Financial Information", when assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, the auditor will need to consider whether-

- (i) the presentation of prospective financial information is informative and not misleading;
 - (ii) the accounting policies are clearly disclosed in the notes to the prospective financial information;
 - (iii) the assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;
 - (iv) the date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;
 - (v) the basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and
 - (vi) there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements and whether reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.
- (b) **Appointment of First Auditor of a Government Company:** According to section 139(7) of the Companies Act, 2013, the first auditor of a government company shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. As per section 2(45) of the said Act, a Government Company is defined as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary company of such a Government Company.

In the given case, M/s IO Ltd. is a government company as its 27% of paid-up share capital has been held by Central Government, 28% by State Government and remaining 45% by Public i.e. total 55% of the paid-up share capital has been held by Central Government and State Government which is more than 51% as prescribed in the Companies Act, 2013

Therefore, the appointment of RMG, Chartered Accountants as first auditor by the Board of Directors of M/s IO Ltd. for the financial year 2014-15 is not valid as the first auditor of a government company can be appointed by Comptroller and Auditor-General of India. If the CAG fails to make such appointment within 60 days, the Board of Directors shall appoint within next 30 days.

(c) M/s MK Associates, as an internal auditor of M/s ME Ltd., manufacturing company will be covering the below mentioned specified areas while drawing the plan for internal audit:

- ◆ Terms of his engagement and any statutory responsibilities.
- ◆ Nature and timing of reports or other communication.
- ◆ Applicable legal or statutory requirements.
- ◆ Accounting policies adopted by the client and changes in those policies.
- ◆ Effect of new accounting or auditing pronouncements on the audit.
- ◆ Identification of significant audit areas.
- ◆ Setting of materiality levels for audit purposes.
- ◆ Conditions requiring special attention, such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- ◆ Degree of reliance he expects to be able to place on accounting system and internal control.
- ◆ Nature and extent of audit evidence to be obtained.
- ◆ Determining the nature, timing and extent of procedures to be performed.
- ◆ Setting the time budget for each of the activities.
- ◆ Involvement of experts.
- ◆ Establishing and coordinating staffing requirements.
- ◆ How the inventory verification will be witnessed?
- ◆ Manner of verifying the records of scrap or wastage (normal/abnormal).
- ◆ Method of physical verification of cash and investment.
- ◆ How the fixed assets shall be verified?
- ◆ The internal audit plan should also identify the benchmarks against which the actual results of the activities, the actual time spent, the cost incurred would be measured.

(d) **Decision to rescind the Recommended Dividend:** Dividend is firstly recommended by the Board. Thereafter, the members in the Annual General Meeting (AGM) may declare the dividend by passing ordinary resolution. The members may reduce the rate or amount recommended by the Board, but they cannot increase it.

Section 123 of the Companies Act, 2013, provides that the dividend shall be declared or paid by a company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in prescribed manner.

Further, as per section 127 of the Act, dividends once declared become the liability of the company and must be paid within 30 days from the date of declaration. Any failure to do so attract a penalty for the various persons associated with the management.

Here in the instant case, Board of Directors of ACP Ltd. has recommended the dividend in their meeting. Such dividend is not declared in AGM. Further, Board has decided to rescind the decision before the date of Annual General Meeting. Thus, the dividend which is only recommended and not declared does not attract penal provisions.

Therefore, Board of Directors may rescind their decision to recommend dividend.

Question 4

- (a) *Mr. Arjun, a newly qualified Chartered Accountant started his practice wants to specialise in Audits of corporates and requires your advice on criminal liabilities of an auditor under the Companies Act, 2013. Kindly guide him. (4 Marks)*
- (b) *During the course of audit of M/s CT Ltd. for the financial year 2014-15, it has noticed that ₹ 2.00 lakhs of employee contribution and ₹ 9.50 lakhs of employer contribution towards employee state insurance contribution have been accounted in the books of accounts in respective heads. Whereas, it was found that ₹ 4.00 lakhs only has been deposited with ESIC department during the year ended 31st March, 2015. The Finance Manager informed the auditor that due to financial crunch they have not deposited the amount due, but will deposit the amount overdue along with interest as and when financial position improves. Comment as a statutory auditor. (4 Marks)*
- (c) *Kalmani & Co. Chartered Accountants have been appointed by C & AG for performance audit of a sugar industry. What factors should be considered by Kalmani & Co., while planning a performance audit of a sugar industry? (4 Marks)*
- (d) *B Pvt. Ltd. started stock broking activities in 2015 and for which it acquired membership of a stock exchange for ₹ 150 lakhs. While finalizing the accounts, the company disclosed the above amount under fixed assets schedule as "Stock Exchange Membership Rights". The company also did not write off any amount since the rights would enable the company to perpetually carry on its business. (4 Marks)*
- As a statutory auditor how would you deal with the above situation? (4 Marks)*

Answer

- (a) **Criminal Liability of an Auditor under the Companies Act, 2013:** The circumstances in which an auditor can be prosecuted under the Companies Act and the penalties to which he may be subjected are briefly stated below-
- (i) **Criminal liability for Misstatement in Prospectus-** As per section 34 of the Companies Act, 2013, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included

or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be liable for punishment u/s 447.

- (ii) **Punishment for False Statement-** According to section 448 of the Companies Act, 2013, if in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement which is false in any material particulars, knowing it to be false; or which omits any material fact, knowing it to be material, he shall be liable for punishment u/s 447.

As per the provisions of the Companies Act 2013, the person involved in abovementioned criminal liabilities or fraud shall be punishable with imprisonment and shall also be liable to fine which shall not be less than the amount involved in the fraud.

- (b) **Non-Compliance of Laws and Regulations & Reporting Requirements:** As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, the auditor is required to report under clause (vii)(a) of Para 3 of CARO, 2015 whether the company is regular in depositing undisputed statutory dues including employees' state insurance with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of rupees 7.50 lakhs in his report.

- (c) **Factors to be considered while planning the Performance Audit:** While planning a performance audit of Sugar Industry, the auditors should take care of certain factors which are listed below-
- (i) to consider significance and the needs of potential users of the audit report.
 - (ii) to obtain an understanding of the-program to be audited.
 - (iii) to consider legal and regulatory requirements.

- (iv) to consider management controls.
 - (v) to identify criteria needed to evaluate matters subject to audit.
 - (vi) to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.
 - (vii) to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.
 - (viii) to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.
- (d) **Stock Exchange Membership Rights:** B Pvt. Ltd. has paid ₹ 150 lakhs for acquiring membership of stock exchange. Such membership rights provide exclusive right to B Pvt. Ltd. for carrying out stock broking activities. Thus, Stock Exchange Membership Rights are controlled by B Pvt. Ltd. and provide the basis for generating economic benefits to it. All these criteria appear to meet the definition of intangible assets as laid down in AS 26 "Intangible Assets". The Standard requires an entity to recognize an intangible asset if it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise and the cost of the asset can be measured reliably.

In the instant case, membership rights of stock exchange acquired by B Pvt. Ltd. meet the criteria of identifiability, control and arising of future benefits as well as reliability of the amount of cost. Thus, recognizing the membership rights as Fixed Assets is proper.

However, the fact that the company did not write-off any amount since it would enable the company to perpetually carry on its business is not proper since AS 26 requires that all Intangible Assets to be amortised. For this purpose, a rebuttable presumption of 10 years is to be considered.

Hence in the instant case, the company should have amortised such rights over 10 years. Since the company has not amortised any amount, the auditor will have to qualify his report and state the fact of non-compliance with AS 26.

Question 5

Comment on the following with reference to CA Act, 1949.

- (a) *Mr. Ankit, who passed his CA examination of ICAI on 18th July, 2015 had started his practice from 15th August, 2015. On 16th August, 2015 one candidate approached him for articleship. Mr. Ankit decided to give her 1% profits of his CA firm in addition to monthly stipend. She agreed to take both 1% of profits and prescribed stipend. The ICAI had sent a letter to Mr. Ankit objecting the payment of 1% profits.*

Mr. Ankit replied stating that sharing 1% profits is over and above the stipend to help the articled clerk to overcome her financial crisis. Is Mr. Ankit liable for Professional misconduct? (4 Marks)

- (b) *Mr. X is a practicing Chartered Accountant. Mr. Y is a practicing Advocate representing matters in the court of law. X and Y decided to help each other in the matters involving their professional expertise. Accordingly, Mr. X recommends Mr. Y in all litigation matters in the court of law and Y consults X in all matters relating to finance and other related matters, which comes to him in arguing various cases. Consequently they started sharing profits of their professional work. Is Mr. X liable for professional misconduct? (4 Marks)*
- (c) *CA Raghu is practicing in the field of Income-tax over a period of 12 years. He has gained experience in this domain over others.*

Sam, a student of Chartered Accountancy Course is very much impressed with the knowledge of CA Raghu. He approached CA Raghu to take guidance on some topics of Income-tax related to his course. CA Raghu, on request decided to spare time and started providing private tutorship to Sam and some of his friends alongwith. However, he forgot to take specific permission from the ICAI, for such private tutorship.

Is CA Raghu, professionally liable for misconduct? (4 Marks)

- (d) *CA P and CA Q are running a firm of Chartered Accountants in the name of M/s. PQ & Co. On 21.06.2015 they included the name of CA R a practicing CA, without his knowledge, as a partner while submitting an application for empanelment as auditors for public sector banks branches to the institute.*

Whether CA P and CA Q are professionally liable for misconduct? (4 Marks)

Answer

- (a) **Sharing Fees with an Articled Clerk:** As per Clause (2) of Part I of First Schedule to the Chartered Accountants Act 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

In view of the above, the objections of the Institute of Chartered Accountants of India, as given in the case, are correct and reply of Mr. Ankit, stating that he is paying 1 % profits of his firm over and above the stipend to help the articled clerk to overcome her financial crisis is not tenable.

Hence, Mr. Ankit is guilty of professional misconduct in terms of Clause (2) of Part I of First Schedule to the Chartered Accountants Act, 1949.

- (b) **Sharing and Accepting of Part of Profits with an Advocate:** According to Clause (2) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualification as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India.

Furthermore, Clause (3) of Part I of the First Schedule to the said Act states that a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he accepts any part of the profits of the professional work of a person who is not a member of the Institute.

However, a practicing member of the Institute can share fees or profits arising out of his professional business with such members of other professional bodies or with such other persons having such qualifications as prescribed by the Council under the Chartered Accountants Regulations, 1988. Under the said regulations, the member of "Bar Council of India" is included.

Therefore, Mr. Y, an advocate, a member of Bar Council, is allowed to share part of profits of his professional work with Mr. X. Hence, Mr. X, a practicing Chartered Accountant, will not be held guilty under any of the abovementioned clauses for paying and accepting part of profits from Mr. Y.

- (c) **Permission for Providing Private Tutorship:** As per Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage.

Further, the Chartered Accountants Regulations, 1988 provides that a Chartered Accountant in practice shall not engage in any other business or occupation other than the profession of accountancy except with the permission granted in accordance with a resolution of the Council. According to the same there is no specific permission from the council would be necessary in the case of private tutorship.

In the given case, CA. Raghu has started providing private tutorship to Mr. Sam along with some of his friends, without obtaining specific or prior approval of the Council.

On this context, it may be noted that the Council has provided general permission for providing such private tutorship. Therefore, CA. Raghu would not be held guilty of professional misconduct under Clause (11) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

- (d) **Submitting Wrong Information to the Institute:** As per Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case, CA. P and CA. Q, partners of M/s PQ & Co., included the name of CA. R, another Chartered Accountant in practice, as partner in their firm, without his knowledge, in their application for empanelment as auditor of branches of Public Sector Banks submitted to the Institute. However, such a member was not a partner of the said firm as on the date of application submitted. Here, CA. P and CA. Q have submitted wrong information to the Institute.

Therefore, CA. P and CA. Q, both, would be held guilty of professional misconduct under Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.

Question 6

- (a) *K Ltd. changed its employee remuneration policy from 1st of April 2015 to provide for 12% contribution to provident fund on leave encashment also. The leave encashment policy provides that employees can either utilize or encash it. As at 31st March, 2016, the company obtained an actuarial valuation for leave encashment liability. However, it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution would be made. It is further contended that this treatment is correct as it is not sure whether employees will avail leave encashment or utilize it. Comment.* (4 Marks)
- (b) *While auditing Suryakiran Insurance Ltd. as on 31st March, 2015, you observed that there is one policy which has been issued on 25th March, 2015 towards fire risk favouring one of the leading corporate houses in the country without the actual receipt of premium and it was reflected as premium receivable. It is the usual practice maintained by the company in respect of big customers that they would issue the policy before receiving the premium. The premium money was collected on 5th of April 2015. It is further noticed that there was a fire accident in the premises of insured on 31st March, 2015 and a claim was lodged. The insurance company also provided for the same.*
- How would you respond?* (4 Marks)
- (c) *ABC Pvt. Ltd. and XYZ Pvt. Ltd. are the Companies in which public are not substantially interested.*

During the previous year 2015-16, ABC Pvt. Ltd. received some property being shares of XYZ Pvt. Ltd. The details of which are provided below:

No. of Shares	1000
Face Value	₹ 10 per share
Aggregate Fair Market Value	₹ 1,00,000
Consideration Value	Nil

As the tax auditor how would you deal with the situation? (4 Marks)

- (d) You are appointed as tax auditor of Mr. X, a practicing advocate in Agra. During the previous year he collected Service Tax of ₹ 7 lakhs but utilized for personal use. The Commissioner of Central Excise issued a show cause notice to him why the tax collected by him is not deposited to the Government account. He appeared before the Commissioner and stated his inability to pay the sum due to financial crisis. The proceedings are still pending. Mr. X requests you not to disclose his Service Tax registration details while filling particulars to be furnished in Form No. 3CD.

As a tax auditor how would you deal with this? (4 Marks)

Answer

- (a) As per AS-15 on “Employee Benefits”, issued by the Institute of Chartered Accountants of India, an enterprise should recognize the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences, when the employees render service that increases their entitlement to future compensated absences.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the compensated absences are accumulating in nature. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, K Ltd. will accumulate the amount of leave encashment benefits as it is the liability of the company to provide 12% PF on amount of leave encashment. Hence, the contention of the auditor is correct that full provision should be provided by the company.

- (b) **Provision for Claim:** No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner. The premium receipt of insurance companies carrying on general insurance business normally arise out of three sources, viz., premium received from direct business, premium received from reinsurance business and the share of co-insurance premium.

In view of the above, the insurance company is not liable to pay the claim and hence no provision for claim is required.

- (c) **Reporting for Receipt of Shares, the Aggregate Fair Market Value of Which Exceeds ₹ 50,000:** In this case, ABC Pvt. Ltd. is a company other than a company in which the public are substantially interested. During the previous year 2015-16, the company received property being shares, for no consideration, the aggregate fair market value of which is ₹ 1,00,000.

Provisions and Explanations: A tax auditor has to furnish the details of shares received during the previous year under Clause (28) of Form 3CD, in case, the assessee has received any property being share of a company not being a company in which public are substantially interested, without consideration or for inadequate consideration as referred to in section 56(2)(viiia) of the Income Tax Act, 1961.

Section 56(2)(viiia) provides that where a firm or a company not being a company in which the public are substantially interested, receives, in any previous year any property being shares of a company not being a company in which the public is substantially interested, without consideration, the aggregate fair market value of which exceeds ₹ 50,000, the whole of the aggregate fair market value of such property shall be chargeable to income-tax under the head "Income from other sources".

Conclusion: As per the facts of the case, provisions and explanations given above, the income generated by ABC Pvt. Ltd., being whole of the aggregate fair market value of shares received (i.e. ₹ 1,00,000), is chargeable to income-tax under the head "Income from other sources" as per section 56(2)(viiia) of the Income Tax Act, 1961.

Therefore, the tax auditor of ABC Pvt. Ltd. is required to furnish the details of such shares received under Clause (28) of Form 3CD.

- (d) **Reporting Requirement Under Clause (4) of Form 3CD:** Mr. X has defaulted in payment of service tax for the previous year. Consequently, the Commissioner of Central Excise issued a show cause notice for such non-payment of tax. The proceedings are still pending. He also restrained his tax auditor from disclosing service tax registration details in tax audit report.

Provisions and Explanations: A tax auditor is required to report under Clause (4) of Form 3CD, which requires him to mention the registration number or any other identification number, if any, allotted, in case the assessee is liable to pay indirect taxes like excise duty, service tax, sales tax, customs duty, etc. The reporting is however, to be done in the manner or format specified by the e-filing utility in this context.

Conclusion: Therefore, the tax auditor of Mr. X is required to furnish service tax registration number under Clause (4) of the Form 3CD. Thus, contention of Mr. X not to disclose the service tax details is not tenable.

Question 7

Write short notes on any **four** of the following:

- (a) *Deferred Taxation* (4 Marks)
- (b) *Exceptions to the General Rule of treating advances as Non performing Assets.* (4 Marks)
- (c) *Advantages that accrue because of cost audit.* (4 Marks)
- (d) *Matters to be included in Auditor's Report in case of NBFC not accepting deposits.* (4 Marks)
- (e) *Areas to be reviewed in the assessment of independence of the practicing unit, while conducting peer review.* (4 Marks)

Answer

- (a) **Deferred Taxation:** AS 22, "Accounting for Taxes on Income", prescribes the accounting treatment for taxes on income. The amount of taxable income for a period and the amount of profit (or loss) as shown by the profit and loss account for that period are seldom the same. The difference between accounting income and taxable income arise due to the fact that taxable income is calculated in accordance with tax laws whose requirements regarding computation of taxable income differ from the accounting policies applied to determine accounting income. The difference between taxable income and accounting income can be classified into 'permanent differences' and 'timing differences'. 'Permanent differences' are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. Timing differences, on the other hand, are those differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods. The standard requires that deferred tax should be recognized for all timing differences, subject to the consideration of prudence in respect of deferred tax assets. Deferred tax represents the future tax effects of timing differences. Some timing differences are such that their reversal in future year(s) would result in the taxable income for the year(s) of reversal being higher than the accounting income for that year (or those years).
- (b) **Exceptions to the General Rule of treating advances as Non-performing Assets:** RBI has laid down norms for classification of assets and provisioning norms for NPAs. However, certain exceptions to these norms are discussed below-
 - (i) **Temporary deficiencies**, e.g., non-availability of current drawing power due to non-receipt of latest stock statement, temporary delay in renewals of limits on due date, etc.
 - (ii) **Natural Calamities:** Where, in the wake of natural calamities, short-term agricultural loans are converted into term loans or there is rescheduling of repayment period or fresh short-term loans are sanctioned, the term loan as well as

fresh short term loan may be treated as current dues and need not be classified as NPA.

- (iii) **Facilities Backed by Central Government Guarantees:** Credit facilities backed by guarantee of the Central Government though overdue should be treated as NPA only when the government repudiates its guarantee when invoked (this exemption is only for the purpose of asset classification and provisioning and not for the purpose of recognition of income).
 - (iv) **Advances to "On Lending" arrangements** are also exempted under this category.
- (c) **Advantages that accrue because of Cost audit:** Cost Audit will be advantageous to the stake holders in the following manner-

To Management -

- (i) Management will get reliable data for its day-to-day operations like price fixing, control, decision-making, etc.
- (ii) A close and continuous check on all wastages will be kept through a proper system of reporting to management.
- (iii) Inefficiencies in the working of the company will be brought to light to facilitate corrective action.
- (iv) Management by exception becomes possible through allocation of responsibilities to individual managers.
- (v) The system of budgetary control and standard costing will be greatly facilitated.
- (vi) A reliable check on the valuation of closing inventory and work-in-progress can be established.
- (vii) It helps in the detection of errors and fraud.

To Society -

- (i) Cost audit is often introduced for the purpose of fixation of prices. The prices so fixed are based on the correct costing data and so the consumers are saved from exploitation.
- (ii) Since price increase by some industries is not allowed without proper justification as to increase in cost of production, inflation through price hikes can be controlled and consumers can maintain their standard of living.

To Shareholder - Cost audit ensures that proper records are kept as to purchases and utilisation of materials and expenses incurred on wages, etc. It also makes sure that the valuation of closing inventories and work- in-progress is on a fair basis. Thus the shareholders are assured of a fair return on their investment.

To Government -

- (i) Where the Government enters into a cost-plus contract, cost audit helps government to fix the price of the contract at a reasonable level.
 - (ii) Cost audit helps in the fixation of ceiling prices of essential commodities and thus undue profiteering is checked.
 - (iii) Cost audit enables the government to focus its attention on inefficient units.
 - (iv) Cost audit enables the government to decide in favour of giving protection to certain industries.
 - (v) Cost audit facilitates settlement of trade disputes brought to the government.
 - (vi) Cost audit and consequent management action can create a healthy competition among the various units in an industry. This imposes an automatic check on inflation.
- (d) **Matters to be included in the Auditor's Report of Non-Banking Financial Company (NBFC) not accepting deposits:** The auditor's report on the accounts of a NBFC shall include a statement on the following matters, namely-
- (1) **In the case of all NBFC-**
 - (i) Whether the company is engaged in the business of non-banking financial institution and whether it has obtained a Certificate of Registration (CoR) from the Bank.
 - (ii) In the case of a company holding CoR issued by the Bank, whether that company is entitled to continue to hold such CoR in terms of its asset/income pattern as on March 31 of the applicable year.
 - (2) **In the case of a non-banking financial company not accepting public deposits- Apart from the aspects enumerated in (1) above, the auditor shall include a statement on the following matters, namely:**
 - (i) Whether the Board of Directors has passed a resolution for non-acceptance of any public deposits.
 - (ii) Whether the company has accepted any public deposits during the relevant period/year.
 - (iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it.
 - (iv) In respect of Systemically Important Non-deposit taking NBFCs -
 - (a) whether the capital adequacy ratio as disclosed in the return submitted to the Bank has been correctly arrived at and whether such ratio is in compliance with the minimum CRAR prescribed by the Bank;

- (b) whether the company has furnished to the Bank the annual statement of capital funds, risk assets/exposures and risk asset ratio within the stipulated period.
- (e) **Review in the Assessment of Independence of the Practicing Unit:** A practicing Chartered Accountant should review following controls in respect of assessment of independence of the practicing unit-
 - (i) Does the practice unit have a policy to ensure independence, objectivity and integrity, on the part of partners and staff? Who is responsible for this policy?
 - (ii) Does the practice unit communicate these policies and the expected standards of professional behaviour to all staff?
 - (iii) Does the practice unit monitor compliance with policies and procedures relating to independence?
 - (iv) Does the practice unit periodically review the practice unit's association with clients to ensure objectivity and independence?