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PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any five from the rest

Question 1

- (a) *In the Notes to Accounts of Z Co. Ltd. as on 31-03-2014 Note no. 10 states that certain machinery items are lying at customs warehouses and that the Company has paid ₹ 500 lakhs up to 30-06-2013 as detention charges, out of which a sum of ₹ 220 lakhs is written back during the year 2013-14 based on settlement with the concerned authorities in respect of a major spares of machinery. For the remaining machinery items, negotiations are pending and a provision of ₹ 48 lakhs has been made. As such a total amount of ₹ 328 lakhs paid/provided on account of detention charges have been capitalized and included in the Fixed Assets/Capital work in progress. The Management is of the view that these expenses are directly attributable to the acquisition of the related Fixed Assets. As the auditor how would you respond to this? (5 Marks)*
- (b) *The Auditor of PQR Pvt. Ltd. having turnover of ₹ 12 crore, was not able to get the confirmation about the existence and value of certain stock. However, a certificate from the Management has been obtained regarding the existence and value of the stock at the year end. The auditor relied on the same and without any further procedure, signed the Audit Report. Is he right in his approach? (5 Marks)*
- (c) *Discuss the impact of uncorrected misstatements identified during the audit and the auditor's response to the same. (5 Marks)*
- (d) *What are the roles and responsibilities of the statutory auditors in relation to compliance with the laws and regulations by the entity? (5 Marks)*

Answer

- (a) **Capitalization of Detention Charges for Fixed Assets lying at Custom Warehouses:**
As per AS 10 "Accounting for Fixed Assets", the cost of an item of fixed asset comprise its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use.

Generally, detention charges represent an abnormal expenditure, as these expenditures are not directly attributable to the cost of asset.

In the case of Z Co. Ltd., the auditor will qualify the report appropriately in the paragraph before stating that the Balance Sheet gives true and fair view and the Statement of Profit and Loss shows true and fair profit of the year ending on 31-3-2014. The qualification will be as follows:

"Attention is invited to Note no. 10 regarding Capitalization of detention charges of ₹ 328 lakhs during the year and on account of delays in respect of clearing from custom

warehouses for certain machinery items. In our opinion the detention charges are not directly attributable to the acquisition of related fixed assets. The said amount of ₹328 lakhs should have been written off in the Statement of Profit and Loss. Had these expenses been so written off, the profits for the year would have been lower by ₹ 328 lakhs and Reserves & Surplus as well as Fixed Assets/Capital WIP would have been lower by ₹ 328 lakhs."

- (b) **Validity of Written Representation:** The physical verification of stock is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence and valuation of stock. In the case of PQR Pvt. Ltd., the auditor has not been able to verify the existence and value of certain stock despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry.

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

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

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

- (c) **Uncorrected Misstatements identified during the Audit:** In accordance with SA 450 "Evaluation of Misstatements identified during the Audit", the auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

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

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

The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

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

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

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

(d) Roles and Responsibilities of the Auditor in relation to compliance with the Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", as part of obtaining an understanding of the entity and its environment the auditor shall obtain a general understanding of:

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

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

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

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

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

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

Question 2

- (a) *While commencing the statutory audit of ABC Company Limited, what should be the considerations of the auditor to assess Risk of Material Misstatement and his response to such risks?* (4 Marks)
- (b) *How would the method of collecting audit evidence relating to effectiveness of controls and evaluating the same change under a computerized environment?* (4 Marks)
- (c) *Describe the principal methods of selection of samples.* (4 Marks)
- (d) *Describe how you would identify the inherent risk at the account balance and class of transaction level in the planning process of the audit of a large multi-locational company.* (4 Marks)

Answer

- (a) **Considerations of Auditor for Assessing the Risk of Material Misstatement:** As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall:
 - (i) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
 - (ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
 - (iii) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
 - (iv) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

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

- (i) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - (1) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure; and
 - (2) Whether the risk assessment takes into account the relevant controls, thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively; and
 - (ii) Obtain more persuasive audit evidence the higher the auditor's assessment of risk.
- (b) Changes in methods of Collecting and Evaluating the Audit Evidences in Computerised Environment:** Auditor must provide a competent, independent opinion as to whether the financial statements records and report a true and fair view of the state of affairs of an entity. However, computer systems have affected how auditors need to collect and evaluate evidence. These aspects are discussed below:
- (i) **Changes as to Evidence Collection** - Collecting evidence on the reliability of a computer system is often more complex than collecting evidence on the reliability of a manual system. Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system, like:
 - (1) accurate and complete operations of a disk drive may require a set of hardware controls not required in manual system,
 - (2) system development control include procedures for testing programs that again are not necessary in manual control.

Since, Hardware and Software develop quite rapidly, understanding the control technology is not easy. With increasing use of data communication for data transfer, research is focused a cryptographic controls to protect the privacy of data. Unless auditor's keep up with these developments, it will become difficult to evaluate the reliability of communication network competently.

The continuing and rapid development of control technology also makes it more difficult for auditors to collect evidence on the reliability of controls. Even collection of audit evidence through manual means is not possible. Hence, auditors have to run through computer system themselves if they are to collect the necessary evidence.

- (ii) **Changes as to Evidence Evaluation** - With increasing complexity of computer systems and control technology, it is becoming more and more difficult for the auditors to evaluate the consequences of strength and weaknesses of control mechanism for placing overall reliability on the system.

Auditors need to understand:

- (1) whether a control is functioning reliably or multi functioning,
- (2) traceability of control strength and weakness through the system. In a shared data environment a single input transaction may update multiple data item used by diverse, physically disparate user, which may be difficult to understand.

Consequences of errors in a computer system are a serious matter as errors in computer system tend to be deterministic, i.e., an erroneous program will always execute data incorrectly. Moreover, the errors are generated at high speed and the cost and effort to correct and rerun program may be high. Errors in computer program can involve extensive redesign and reprogramming. Thus, internal controls that ensure high quality computer systems should be designed implemented and operated upon. The auditors must ensure that these control are sufficient to maintain assets safeguarding, data integrity, system effectiveness and system efficiency and that they are in position and functioning.

- (c) **Principle methods of selection of samples:** According to SA 530 "Audit Sampling", the principal methods of selecting samples are the use of random selection, systematic selection, monetary unit sampling selection, haphazard selection and block selection. Each of these methods is discussed below-
- (i) **Random selection:** This method is applied through random number generators, for example, random number tables.
 - (ii) **Systematic selection:** In this method the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables.
 - (iii) **Monetary Unit sampling:** This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
 - (iv) **Haphazard selection:** In this method the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
 - (v) **Block selection:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different

characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

- (d) **Evaluating Inherent Risk:** To assess inherent risk, the auditor would use professional judgment to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment.

Inherent audit risk at the level of Account Balance and Class of Transactions is:

- (i) Quality of the accounting system.
- (ii) Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
- (iii) The complexity of underlying transactions and other events which might require using the work of an expert.
- (iv) The degree of judgement involved in determining account balances.
- (v) Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- (vi) The completion of unusual and complex transactions, particularly at or near period end.
- (vii) Transactions not subjected to ordinary processing.

Question 3

- (a) *Big and small Ltd. received a show cause notice December 2013 from the Central Excise department intending to levy a sum of ₹ 25 lakhs. The Company replied to the above notice in January, 2014 contending that it is not liable for the proposed levy. No further action was initiated by the Central Excise department up to the finalization of the audit for the year ended on 31st March, 2014. As the Auditor of the Company, how would you deal with this matter in your report? (3 Marks)*
- (b) *The Auditor's Report of ABC Ltd. for the year 2012-13 contained a qualification regarding non-provision of doubtful debts. As the Statutory Auditor of the Company for the year 2013-14, how would you report, if:*
- (i) *the Company does not make provision for doubtful debts in 2013-14?*
 - (ii) *the Company makes adequate provision for doubtful debts in 2013-14? (5 Marks)*

- (c) *What are the professional obligations of the auditor who has resigned from the audit before completion of his term due to non co-operation of the Management in completing certain audit procedures?* (5 Marks)
- (d) *Discuss the Auditor's responsibility to provide access to his audit working papers to Regulators and third parties.* (3 Marks)

Answer

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

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. Then the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. In case, if the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

In the present case of Big and Small Ltd., issuance of show cause notice by Excise Department does not tantamount to demand payable by the Company. In so far as the Company has replied to the notice and no further correspondence was received from the Department. This show cause notice may be an alert or indication of non-compliance for the auditor. So auditor need to discuss with management and apply additional procedure. If the auditor concludes that there is non-compliance then provision for the same should be made as per AS 29. If the management does not accept the request the auditor should qualify the audit report accordingly or *vice versa*.

- (b) **Reporting of qualification regarding non-provision of doubtful debts:** Auditor's responsibility in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and

the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

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

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

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

- (c) **Resignation due to Management Imposing Limitation on the Scope of Audit:** SA 705 "Modifications to the Opinion in the Independent Auditor's Report" provides the consequence of an inability to obtain sufficient appropriate audit evidence due to a management-imposed limitation after the auditor has accepted the engagement. The practicability of resigning from the audit may depend upon the stage of completion of the engagement at the time that management imposes the scope limitation.

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

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

Alternatively answer may be given as per SA 210, Agreeing the Terms of Audit Engagements.

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

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

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

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

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

Question 4

- (a) A Private Limited Company reports the following position as on 31st March, 2014:

<i>Paid up Capital</i>	<i>₹ 35 Lacs</i>
<i>Revaluation Reserve</i>	<i>₹ 12 Lacs</i>
<i>Capital Reserve</i>	<i>₹ 10 Lacs</i>
<i>Profit & Loss (Dr.) Balance</i>	<i>₹ 12 Lacs</i>

The Management of the Company contends that CARO, 2003 is not applicable to it.
Comment. (4 Marks)

- (b) You are appointed to compile financial statements of Z & Company (a partnership firm) for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing out the same, the partners of Z & Co., tell you that it is

outside your scope since you are not conducting an audit and the said figures duly certified by the firm should be accepted. Comment. (4 Marks)

- (c) *C Limited has defaulted in repayments of dues to a financial institution during the financial year 2013-14 and the same remained outstanding as at March 31, 2014. However, the Company settled the total outstanding dues including interest in April, 2014 subsequent to the year end and before completion of the audit. Discuss how you would deal with this matter and draft a suitable Auditor's Report. (4 Marks)*
- (d) *In the course of your audit you have come across a related party transaction which prima facie appears to be biased. How would you deal with this? (4 Marks)*

Answer

- (a) **Applicability of CARO, 2003:** As per the Statement on CARO, 2003 issued by ICAI, for determining the applicability of the CARO, 2003 to a private limited company, both capital as well as the revenue reserves shall be taken into consideration while computing the limit of rupees fifty lakhs prescribed for paid up capital and reserves. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance in the profit and loss account, if any, should be reduced from the figure of revenue reserves only. If the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures of paid up capital, capital reserve and revaluation reserve.

Accordingly the profit and loss account (Dr. balance) of ₹12 lakhs cannot be deducted and hence CARO, 2003 is applicable to the Company.

- (b) **Engagement to Compile Financial Information and Misstatements:** As per SRS 4410 "Engagements to Compile Financial Information", if the accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading, the accountant should withdraw from the engagement.

As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the stock auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. The tax auditor should also examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In the instant case, appointment was made to compile financial statements for tax audit purpose of Z&Co., a partnership firm. It is our duty to ensure that method followed for valuation of stock results in disclosure of correct profit and gains.

In this case, the stock valuation was grossly understated. Consequently, disclosure of profit is also not correct. Hence, contention of the Z & Co., that you are not conducting an audit, the said figures duly certified by the firm should be accepted is not correct.

- (c) **Reporting requirement as per Schedule III to the Companies Act, 2013:** As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, terms of repayment of term loans and other loans is required to be disclosed in the notes to accounts. It also requires specifying the period and amount of continuing default as on the balance sheet date in repayment of loans and interest, separately in each case.

In the given case, C Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2013-14 which remain outstanding as at March 31, 2014. However, the company has settled the total outstanding dues including interest in April, 2014 but, the dues were outstanding as at March 31, 2014. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

"The company has taken a loan during the year, from a financial institution amounting to ₹ XXXX @ X% p.a. which is repayable by monthly installment of ₹ XXXX for XX months.

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2013-14 amounting to ₹ XXXX which remained outstanding as at March 31, 2014. However, the outstanding sum was settled by the company in April, 2014."

- (d) **Related Parties:** The duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. Since it is the management, which is primarily responsible for identification of related parties, SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions.

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

- (i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets,

- (ii) The terms of the transactions are consistent with management's explanations; and
- (iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

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

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

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

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

Question 5

- (a) *XYZ Ltd. pays ₹ 90000 for its 6 employees to a Hotel as boarding and lodging expenses of such employees for a conference. The Company pays the amount in cash to the Hotel. The Hotel gives 6 bills each amounting to ₹ 15000. The Company contends that each bill is within the limit, so there is no violation of the provisions of the Income Tax Act, 1961. As the tax auditor, how would you deal with the matter in your tax audit report for the Assessment Year 2014-15?* (4 Marks)
- (b) *ABC & Co., Chartered Accountants are the Auditors of Just Care General Insurance Company Limited. As on March 31, 2014 the Management made a provision for claims outstanding. Enumerate the steps to be taken by the Auditor while verifying the "Claims Provision".* (6 Marks)
- (c) *Compare and explain the following:*
 - (i) *Reporting to Shareholders vs. Reporting to those Charged with Governance* (3 Marks)
 - (ii) *Audit Qualification vs. Emphasis of Matter.* (3 Marks)

Answer

- (a) **Reporting for Payment in Cash above ₹ 20,000 under Form 3CD:** As per section 44AB of the Income Tax Act, 1961, the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in form 3CD.

Disallowance under section 40A(3) of the Income Tax Act, 1961 is attracted if the assessee incurs any expenses in respect of which payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft, exceeds ₹ 20,000. However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted.

In the given case, the tax auditor found that a hotel issued 6 bills to XYZ Ltd. each amounting to ₹ 15,000 for boarding & lodging expenses of 6 employees. XYZ Ltd. in aggregate has paid ₹ 90,000 to the hotel in cash. Consequently, no expenditure shall be allowed for deduction as per the provisions of section 40A(3).

Further more, under clause 17(h) of Form 3CD, amounts inadmissible under section 40A(3) read with rule 6DD have to be reported. Contention of the company that each bill is within the limit is not tenable since aggregate of payments need to be considered.

Therefore, the payments made by the XYZ Ltd. are inadmissible under section 40A(3) of the Income Tax Act, 1961 and hence, needs to be reported under clause 17(h) of Form 3CD.

- (b) **Verification of "Claims Provision" in the case of a General Insurance Company:** The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims. The auditor should satisfy himself that the estimated liability provided for by the management is adequate with reference to the relevant claim files/dockets, keeping in view the following:
- (i) that provision has been made for all unsettled claims as at the year-end on the basis of claims lodged/communicated by the parties against the company. The date of loss (and not the date of communication thereof) is important for recording/recognizing the claim as attributable to a particular year.
 - (ii) that provision has been made for only such claims for which the company is legally liable, considering particularly, (a) that the risk was covered by the policy, if in force, and the claims arose during the currency of the policy; and (b) that claim did not arise during the period the company was not supposed to cover the risk.
 - (iii) that the provision made is normally not in excess of the amount insured except in some categories of claims where matters may be sub-judice in legal proceedings

which will determine the quantum of claim, the amount of provision should also include survey fee and other direct expenses.

- (iv) that in determining the amount of provision, events after the balance sheet date have been considered.
- (v) that the claims status reports recommended to be prepared by the Divisional Manager on large claims outstanding at the year-end have been reviewed with the contents of relevant files or dockets for determining excess/short provisions.
- (vi) that in determining the amount of provision, the 'average clause' has been applied in case of under-insurance by parties.
- (vii) that the provision made is net of payments made 'on account' to the parties wherever such payments have been booked to claims.
- (viii) that in case of co-insurance arrangements, the company has made provisions only in respect of its own share of anticipated liability.
- (ix) that wherever an unduly long time has elapsed after the filing of the claim and there has been no further communication and no litigation or arbitration dispute is involved, the reasons for carrying the provision have been ascertained.
- (x) that wherever legal advice has been sought or the claim is under litigation, the provisions is made according to the legal advisor's view and differences, if any, are explained.
- (xi) that in the case of amounts purely in the nature of deposits with courts or other authorities, adequate provision is made and deposits are stated separately as assets and provisions are not made net of such deposits.
- (xii) that no contingent liability is carried in respect of any claim intimated in respect of policies issued.
- (xiii) that the claims are provided for net of estimated salvage, wherever applicable.
- (xiv) that intimation of loss is received within a reasonable time and reasons for undue delay in intimation are looked into.
- (xv) that provisions have been retained as at the year-end in respect of guarantees given by company to various Courts for claims under litigation.
- (xvi) that due provision has been made in respect of claims lodged at any office of the company other than the one from where the policy was taken, e.g., a vehicle insured at Mumbai having met with an accident at Chennai necessitating claim intimation at one of the offices of the company at Chennai.

In cases of material differences in the liability estimated by the management and that which ought to be provided in the opinion of the auditor, the same must be brought out in

the auditor's report after obtaining further information or explanation from the management.

(c) (i) **Reporting to Shareholders vs. Reporting to those Charged with Governance:**

REPORT	
Reporting to Shareholders	Reporting to those Charged with Governance
<ul style="list-style-type: none"> Section 143 of the Companies Act, 2013 deals with the provisions relating to reporting to Shareholders. Thus, it is a Statutory Audit Report which is addressed to the members. 	<ul style="list-style-type: none"> Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.
<ul style="list-style-type: none"> Statutory Audit Report is on true and fair view and as per prescribed Format. 	<ul style="list-style-type: none"> It is a reporting on matters those charged with governance like scope of audit, audit procedures, audit modifications, etc.
<ul style="list-style-type: none"> Statutory Audit Reports are in public domain. 	<ul style="list-style-type: none"> Reporting to those Charged with Governance is an internal document i.e. private report.

(ii) **Audit Qualification vs. Emphasis of Matter:**

REPORT	
Audit Qualification	Emphasis of Matter
<ul style="list-style-type: none"> Standard on Auditing 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification. 	<ul style="list-style-type: none"> Standard on Auditing 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deals with the provisions relating to Emphasis of Matter.
<ul style="list-style-type: none"> Audit Qualifications are also known as "subject to report" or "except that report". 	<ul style="list-style-type: none"> Emphasis of Matter is a paragraph which is included in auditor's report to draw users' attention to important matter(s) which are already disclosed in Financial Statements and are fundamental to users' for understanding of Financial Statements.

<ul style="list-style-type: none"> • Audit Qualifications are given when auditor is having reservations on some of the items out of the financial statements as a whole i.e. Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements relating to if the impact of material misstatements is not pervasive on the financial statements but is present at some levels of the financial statements, qualified report is issued. 	<ul style="list-style-type: none"> • Emphasis of Matter is a paragraph which is issued when there is a uncertainty relating to future outcome of exceptional litigation, regulatory action, etc.; or there is early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
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Question 6

Comment on the following:

- (a) *A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for their operation system. One of the partners of the firm of chartered accountants was a non-executive director of the company. (4 Marks)*
- (b) *Mr. Z, a Chartered Accountant was invited by the Chamber of Commerce to present a paper in a symposium on the issues facing Indian Textile Industry. During the course of his presentation he shared some vital information of his client's business under the impression that it will help the Nation to compete with other countries at the international level. (4 Marks)*
- (c) *M/s. ABC, a firm of Chartered Accountants received ₹ 2 lakhs in March, 2014 from a client to pay the Advance Tax. However, the firm has used that money for its own purpose and later on adjusted the same with the outstanding fee payable. (4 Marks)*
- (d) *M/s. XYZ, a firm of Chartered Accountants has taken a loan for acquiring a home from a company whose Managing Director's son is an Articled Assistant with A, a partner of M/s. XYZ. The Articled Assistant had no direct interest in the Company and the loan was not related to his engagement. (4 Marks)*

Answer

- (a) **Expression of Opinion on Financial Statements:** Clause 4 of Part I of the Second Schedule to Chartered Accountants Act, 1949, states that expressing an opinion on financial statements of any business or any enterprise in which the auditor, his firm or a

partner in his firm has a substantial interest would constitute misconduct. Also, the Council of the Institute of Chartered Accountants of India has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, should not express any opinion on its financial statements.

As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and moreover its partner was on the Board.

Hence, the firm can perform this assignment and it will not constitute misconduct. However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in independent manner and express opinion on financial statements.

(b) Disclosure of Client's Information: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 deals with the professional misconduct relating to the disclosure of information by a chartered accountant in practice relating to the business of his clients to any person other than his client without the consent of his client or otherwise than as required by any law for the time being in force would amount to breach of confidence. The Code of Ethics further clarifies that such a duty continues even after completion of the assignment. The Chartered Accountant may however, disclose the information in case it is required as a part of performance of his professional duties. In the given case, Mr. Z, a Chartered Accountant, has disclosed vital information of his client's business without the consent of the client under the impression that it will help the nation to compete with other countries at International level. Thus it is a professional misconduct covered by clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949.

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

M/s. ABC received the money in March, 2014 for payment of the advance tax; hence it should be deposited in a separate bank account. Since in this case M/s. ABC have failed to keep the sum of ₹ 2 lakhs received on behalf of their client in a separate Bank Account, it amounts to professional misconduct under clause 10 of part I of Second Schedule.

(d) Loan from a Company: As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a chartered accountant is deemed to be guilty of professional misconduct if he contravenes any of the provisions of Chartered

Accountants Act, 1949 or Regulations made there under. Regulation 47 of the Chartered Accountant's Regulations, 1988, prohibits a member from accepting any premiums or loans or any deposit in any form from an articled clerk directly or indirectly. However, M/s XYZ has taken loan from a company whose Managing Director happens to be father of articled clerk with Mr. A, a partner of M/s XYZ.

In this case, the articled trainee has no direct interest in that company. There has been a case wherein a chartered accountant was held guilty of professional misconduct because he took a loan from a firm in which the articled clerk and his father were both interested. But, in this case as per the facts, the articled trainee has no direct interest in the company. However, if relationship, direct or indirect, can be established in view of relationship of articled trainee with MD of the company, Mr. A of M/s XYZ would be held liable for professional misconduct.

Thus, M/s XYZ would be guilty of professional misconduct under this clause if it is proved that the loan was related to the engagement of the articled clerk.

Question 7

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

- (a) *Market Wide Circuit Breaker (MWCB)*
- (b) *Restriction on shareholding in a Co-operative Society*
- (c) *Importance of KYC requirements for a Chartered Accountant's practice*
- (d) *Intangible Asset vs. Intangible Item.*
- (e) *Cost Audit*

(16 Marks)

Answer

- (a) **Market Wide Circuit Breakers (MWCB)** - Market wide circuit breakers do the same job for the entire market what circuit filters do for individual scrips. MWCB has been introduced to control excessive market movements in BSE sensex and Nifty. SEBI has introduced MWCB at 10-15-20% of the movements in these indices whichever is breached earlier. These breakers provide the time to participants to react to the movement by way of the trading halt.

The trading halt on the exchange shall be as per following regulations –

- (1) If movement in the index is 10%:

Time of Movement	Duration of trading halt
Before 1 p.m.	1 hour
After 1 p.m. but before 2.30 p.m.	½ hour
On or after 2.30 p.m.	No trading halt

(2) If Movement in the index is 15%:

Time of Movement	Duration of trading halt
Before 1 p.m.	2 hours
After 1 p.m. but before 2 p.m.	1 hour
On or after 2 p.m.	For entire remaining period day

(3) If Movement in the index is 20%: The trading shall halt for remaining period of the day.

(4) Basis for calculating percentages for MWCB: These percentages are not calculated on a day-to-day basis rather they are fixed for a quarter. These are fixed in absolute points of index variation on the basis of the closing of index on the last trading day of previous quarter and are reported in advance to the market participants at the beginning of the relevant quarter.

(b) **Restrictions on share holdings** - According to Section 5 of the Co-operative Societies Act, 1912, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to Rs. 1,000/-. The auditor of a co-operative society will be concerned with this provision so as to watch any breach relating to holding of shares. One should also watch whether any provision in the bye-laws of the society is not contrary to this statutory position. The State Acts may provide limits as to the shareholding, other than that provided in the Central Act.

(c) **Importance of KYC requirements for a Chartered Accountant's Practice:** The financial services industry globally is required to obtain information of their clients and comply with Know Your Client Norms (KYC norms). Keeping in mind the highest standards of Chartered Accountancy profession in India, the Council of ICAI recommended such norms to be observed by the members of the profession who are in practice. These Know Your Client (KYC) Norms are also important in order to ensure a healthy growth of the profession and an equitable flow of professional work among the members.

The self-regulatory measures are recommendatory. However, considering the spirit underlying these measures, it is expected that every Chartered Accountant carrying out attest function is encouraged to follow them and implementation of these measures would go a long way in ensuring equitable flow of work among the members and would also further enhance the prestige of the profession in the society.

(d) **Intangible Asset vs. Intangible Item:** As per Accounting Standard 26 on "Intangible Assets", enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences,

intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

If above discussed items fulfils the conditions given in the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise, will be considered as intangible asset. But if any of such discussed items does not satisfied these 3 conditions then it will not constitute intangible asset, like expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation.

Further, Intangible assets are shown in Balance Sheet whereas intangible items which are not intangible assets are provided as expenditure in Profit and Loss Account.

- (e) **Cost Audit:** It is covered by Section 148 of the Companies Act, 2013. As per section 148 the Central Government may by order specify audit of items of cost in respect of certain companies. Further, the Central Government may, by order, in respect of such class of companies engaged in the production of such goods or providing such services as may be prescribed, direct that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account kept by that class of companies.

It is provided that the Central Government shall, before issuing such order in respect of any class of companies regulated under a special Act, consult the regulatory body constituted or established under such special Act

The audit shall be conducted by a Cost Accountant in Practice who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed.

No person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records and also that the auditor conducting the cost audit shall comply with the cost auditing standards

The qualifications, disqualifications, rights, duties and obligations applicable to auditors under this Chapter X of the Companies Act, 2013 shall, so far as may be applicable, apply to a cost auditor appointed under this section and it shall be the duty of the company to give all assistance and facilities to the cost auditor appointed under this section for auditing the cost records of the company.

It is provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

A company shall within thirty days from the date of receipt of a copy of the cost audit report prepared (in pursuance of a direction issued by Central Government) furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein.