PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

*Answer any **five** from the rest*

Question 1

(a) *Mr. A, a practising Chartered Accountant, has been appointed as an auditor of True Pvt. Ltd. What factors would influence the amount of working papers required to be maintained for the purpose of his audit?* *(5 Marks)*

(b) *M/s T K Projects Limited, a manufacturing company in the Steel industry was allegedly involved in some irregularity relating to allotment of coal blocks for which a complaint was lodged against the company by the government. The financial institutions stopped additional working capital finance which caused a financial crisis resulting in stoppage of production. The company incurred a massive loss during the year 2014-15. There were delays in salary and other payments. Certain key managerial personnel including GM Finance and certain other employees left the company. The company has no sound action plan to mitigate these situations. Guide the statutory auditor on how he should deal with this situation.* *(5 Marks)*

(c) *"If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence of inventory by attending the physical inventory counting unless impracticable". Discuss.* *(5 Marks)*

(d) *P Limited is a listed company and its business activities are divided into three regions. The company appointed PY & Co., KL & Co. and MK & Co., Chartered Accountants to conduct a Joint Audit and report on the financial statements for the Financial Year 2014-15. Explain the relationship among the joint auditors for the audit of the financial statements for the year 2014-15.* *(5 Marks)*

Answer

(a) Factors Influencing the Amount of Working Papers: As per SA 230 "Audit Documentation", which refers to the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached, the amount of audit working papers depend on factors such as-

(i) The size and complexity of the entity.

(ii) The nature of the audit procedures to be performed.

(iii) The identified risks of material misstatement.

(iv) The significance of the audit evidence obtained.

(v) The nature and extent of exceptions identified.

(vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.

(vii) The audit methodology and tools used.

(viii) Timely preparation of Audit Documentation.

(b) Inability to Continue as a Going Concern: As per SA 570 on "Going Concern", it is the responsibility of the auditor to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, M/s T K Projects Limited has incurred massive loss during the year 2014-15 as the financial institutions have stopped financing additional working capital to the company because of a complaint which was lodged against the company by government for involvement in some irregularity relating to allotment of coal blocks. There were delays in salary and other payments. Besides this, certain key managerial personnel, GM Finance and certain other employees have also left the company. The company, in addition, has no sound action plan to mitigate these situations.

Thus, there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action to mitigate these factors, the going concern assumption does not seem appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified opinion. But, if the result of the appropriate assumption used in the preparation of financial statements is material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

(c) Attendance at Physical Inventory Counting When Inventory is Material: According to SA 501 "Audit Evidence - Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending the physical inventory counting, unless impracticable, to –

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting.

(ii) Observe the performance of management's count procedures.

(iii) Inspect the inventory.

(iv) Perform test counts.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

(d) Relationship Among Joint Auditors: SA 299 "Responsibility of Joint Auditors" deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. According to this SA, in respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him.

I. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

   (i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

   (ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

   (iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

   (iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

   (v) for ensuring that the audit report complies with the requirements of the relevant statute.

II. It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

   The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

   Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 2

(a) *In the course of the statutory audit of Z Ltd., its statutory auditors, having determined that the work of internal auditor is likely to be adequate for the purpose of statutory audit, wanted to use the work of the internal auditor in respect of physical verification of fixed assets. How should an evaluation be carried out of this specific work done by the internal auditor?* *(4 Marks)*

(b) *Describe the relevance of SA 600 while auditing consolidation of Financial Statements.*

(4 Marks)

(c) *The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, what are the relevant criteria which determine whether the data is reliable for the purposes of designing substantive analytical procedures?* *(4 Marks)*

(d) *JY & Co. is appointed as auditor of Breeze Ltd. JY & Co. seeks your guidance for reviewing the records and documentation of the company regarding 'related party transactions in the normal course of business'. Describe the steps to be followed.* *(4 Marks)*

Answer

(a) **Evaluation of Specific Work Done by Internal Auditor:** The statutory auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 "Using the Work of Internal Auditors", the nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include examination of items already examined by the internal auditors, examination of other similar items; and observation of procedures performed by the internal auditors.

Further, to determine the adequacy of specific work performed by the internal auditors in respect of physical verification of fixed assets for the external auditor's purposes, the external auditor shall evaluate whether:

(i) The work was performed by internal auditors having adequate technical training and proficiency;

(ii) The work was properly supervised, reviewed and documented;

(iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(iv) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

(v) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

(b) **Relevance of SA 600 While Auditing Consolidation of Financial Statements:** SA 600 'Using the Work of Another Auditor' establishes standards when an auditor, reporting on the financial statements of an entity (the group—in the case of consolidated financial statements), uses the work of another auditor on the financial information of one or more components included in the financial statements of the entity. The principal auditor, if he decides to use the work of another auditor in relation to the audit of consolidated financial statements, should comply with the requirements of SA 600.

While complying with the requirements of SA 600, 'Using the Work of Another Auditor', the principal auditor should keep the following under consideration:

(i) When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

(ii) The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should advise the other auditor of the:

- Information/assurance required by the other auditor; this emanates/precludes the principal auditor's determination of how the work of the other auditor would affect the audit of consolidated financial statements, for example, the information required from the auditor of a subsidiary would be different from that required from the auditor of a joint venture;
- Use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit; and
- Significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

(c) **Relevant Criteria for Determining Reliability of Data:** SA 520 on 'Analytical Procedures' provides that the reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.

Accordingly, the following are relevant criteria when determining whether data is reliable for purposes of designing substantive analytical procedures-

(i) **Source of the information available.** For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

(d) Review of Records and Documentation Regarding Related Party Transaction: According to SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank, legal and third party confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

The auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator etc.

Question 3

(a) You are appointed as the auditor of a NBFC which is an Investment company registered with RBI. What shall be the special points to be covered for the audit of NBFC in case of Investment companies? (4 Marks)

(b) *What can be the possible instances of capital receipt which, if not credited to the Profit and Loss Account, needs to be reported in Form 3CD?* *(4 Marks)*

(c) *Explain the audit of Depositories under the SEBI (Depositories and Participants) Regulations, 1996 and the records and documents which are required to be maintained by the Depositories.* *(4 Marks)*

(d) *XYZ Limited, a company engaged in the business of manufacturing and distribution of copper rods and copper wire is interested in acquiring a listed company having a market share of 38% of Insulated Copper Wires. You were appointed to conduct a "Due Diligence" of the target company and you have completed review of a few key areas. List out the contents of the Due Diligence Report which you will submit to XYZ Limited.*

(4 Marks)

Answer

(a) Special points that may be covered in the audit of NBFCs in case of Investment Companies are given below:

(i) Physically verify all the shares and securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.

(ii) NBFC Prudential Norms stipulates that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.

(iii) Verify whether the NBFC has not advanced any loans against the security of its own shares.

(iv) Verify that dividend income wherever declared by a company, has been duly received by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for.

(v) Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

(vi) Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.

(vii) Check whether the investments have been valued in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.

(viii) Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.

(ix) Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

(x) An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

(xi) In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.

(xii) In the case of securities lent/borrowed under the Securities Lending Scheme of SEBI, verify the agreement entered into with the approved intermediary (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for lending/borrowing) with regards to the period of depositing/lending securities, fees for depositing/lending, collateral securities and provision for the return including pre-mature return of the securities deposited/lent.

(xiii) Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon.)

(xiv) Verify charges received or paid in respect of securities lent/borrowed.

(xv) Obtain a confirmation from the approved intermediary regarding securities deposited with/borrowed from it as at the year end.

(b) Capital Receipts to be reported in Form 3CD: Following are the instances of capital receipts which, if not credited to the profit and loss account, are to be stated under clause 16(e) of Form 3CD -

(i) Capital subsidy received in the form of Government grants which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay.

(ii) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.

(iii) Compensation for surrendering certain rights.

(iv) Profit on sale of fixed assets/investments to the extent not credited to the profit and loss account.

(c) Audit of Depositories: The SEBI (Depositories and Participants) Regulations, 1996 empower SEBI to conduct inspection and audit. The regulation requires that depositories shall have adequate mechanisms for the purposes of reviewing monitoring and evaluating the depository's controls systems, procedures and safeguards.

Depositories are required to maintain the following records and documents, namely:

(i) records of securities dematerialised and rematerialised;

(ii) the names of the transferor, transferee, and the dates of transfer of securities;

(iii) a register and an index of beneficial owners;

(iv) details of the holding of the securities of beneficial owners as at end of each year.

(v) records of instructions received from and sent to participants, issuers, issuers' agents and beneficial owners;

(vi) records of approval, notice, entry and cancellation or pledge or hypothecation, as the case may be;

(vii) details of participants;

(viii) details of securities declared to be eligible for dematerialisation in the depository; and

(ix) such other records as may be specified by the Board for carrying on the activities as a depository.

Every Depository shall intimate the Board, the place where the records and documents are maintained. Subject to the provisions of any other law, the depository shall preserve records and documents for a minimum period of 5 years. Where records are kept electronically by the Depository, it shall ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that the records are not lost, destroyed or tampered with and in the event of loss or destruction, ensure that sufficient back up of records is available at all times at a different place.

(d) Contents of a Due Diligence Report: The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative -

<u>Example of Headings of a Due Diligence Report</u>

I. Executive Summary

II. Introduction

III. Background of Target

IV. Objective of due diligence

V. Terms of reference and scope of verification

VI. Brief history of the company

VII. Share holding pattern

VIII. Observations on the review

IX. Assessment of management structure

X. Assessment of financial liabilities

XI. Assessment of valuation of assets

XII. Comments on properties, terms of leases, lien and encumbrances.

XIII. Assessment of operating results

XIV. Assessment of taxation and statutory liabilities

XV. Assessment of possible liabilities on account of litigation and legal proceedings against the company

XVI. Assessment of net worth

XVII. Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account

XVIII. SWOT Analysis

XIX. Comments on future projections

XX. Status of charges, liens, mortgages, assets and properties of the company

XXI. Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities

XXII. Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.

Question 4

(a) *New Life Hospital is a multi-speciality hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the person in charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. According to you, which basis system of control has been violated? Also list down the other general conditions pertaining to such system which needs to be maintained and checked by the management.* *(4 Marks)*

(b) *What steps needs to be taken to investigate frauds of Cash Receipts?* *(4 Marks)* *(c) Management Audit and Operational Audit are complementary and supplementary to one another. Discuss. (4 Marks)*

(d) Mr. Adnan, a Chartered Accountant in practice, is a partner of 4 firms. While printing his personal letter heads, Mr. Adnan gave the names of all the firms in which he is a partner. Comment. (4 Marks)

Answer

(a) Basic system of Control: Internal Checks and Internal Audit are important constituents of Accounting Controls. Internal check system implies organization of the overall system of book-keeping and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.

In the given case of New Life Hospital, the person-in-charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. Thus, one of the basic system of control i.e. internal check which includes segregation of duties or maker and checker has been violated where transaction processing are allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person.

The general condition pertaining to the internal check system may be summarized as under -

(i) No single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.

(vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised and wide deviations observed should be reconciled.

(viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.

(ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

(b) **Steps to be taken to Investigate Frauds of Cash Receipts:** While investigating frauds of cash receipts, following steps should be taken -

(i) Evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts.

(ii) Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier.

(iii) The details of cash deposited on each day should be compared with those shown in the Cash Book by recalling paying-in-slips from the bank.

(iv) The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated.

(v) Cash sales should be vouched in detail.

(vi) Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them.

(vii) Deductions made on account of cash discounts should be reviewed.

(viii) All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

(c) **Relationship between Management and Operational Audit:** Operational audit is an audit for the management; it is undertaken at the instance of the management for providing it with information and appraisal of operations and activities.

Management audits are concerned with appraising management's accomplishment of organisational objectives; the management functions of planning, organising, directing, and controlling; and the adequacy of management's decisions and actions in moving towards its stated objectives.

The preponderant view about management audit is that it is wider in scope compared to operational audit. However, a distinction should be made between management audit and operational audit. Management audit is concerned with the quality of managing, whereas operational audit centres on the quality of operations. The basic difference between the two audits, then, is not in method, but in the level of appraisal.

The two audits are complementary and supplementary to one another. In management audit, the auditor is to make his tests to the level of top management, its formulation of objectives, plans and policies and its decision making. It is not that he just verifies the operations of control and procedures and fulfillment of plans in conformity with the prescribed policies. He is to reach the root i.e., the functions of top management which lay down objectives and policies, provide means and procedures of implementation and control and which actually engage in direction and control on a continuous basis. In addition to what would normally be covered in an operational audit, management audit would also encompass the relevance and effectiveness of the aims, duties and decisions of management at various levels.

In view of the analysis made above which recognises management audit and operational audit as two identifiable exercises having a large area of overlapping jurisdiction, it may be convenient to consider them together to avoid duplication; and for this purpose the expression "management and operational audit" may be acceptable as a management audit which includes within its scope all the elements of operational auditing.

(d) Advertisement of Professional Attainment: Under clause (7) of Part I of First Schedule of the Chartered Accountant Act, 1949, a CA in practice is deemed to be guilty of professional misconduct if he (i) advertises his professional attainments or services or (ii) uses any designation or expressions other than 'Chartered Accountant" on professional documents, visiting cards, letter heads or sign boards unless it be a degree of a university established by law in India or recognized by the Central Government or a title indicating membership of the ICAI or of any other institution that has been recognized by the Central Government or may be recognized by the council.

In the instant case, Mr. Adnan, a Chartered Accountant in practice, is a partner of 4 firms and while printing his personal letter heads, he gave the names of all the firms in which he is partner.

As per Clause 7 of Part I of First Schedule, there is no prohibition for printing names of all 4 firms on the personal letter heads in which a member holding certificate of practice is a partner.

Thus, Mr. Adnan is not guilty of any professional misconduct in the above case.

Question 5

(a) M/s ASKS, a firm of Chartered Accountants, having three partners accepts an audit assignment of a private limited company for a fee of ₹ 4,000 only. Comment. (4 Marks)

(b) Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in the suburbs of Chennai. Due to increase in the income tax assessment work, he opens another office near the income tax office, which is within the city and at a distance of 30 kms. from his office in the suburb. For running the new office, he has employed a retired Income Tax Commissioner who is not a Chartered Accountant. Comment. (4 Marks)

(c) During the course of his audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in the mind while drafting the letter of weaknesses in internal control system. (4 Marks)

(d) M/s IT Limited has prepared the financial statements for the year 2014-15 and mentioned in the significant accounting policies that depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management. The company has ignored the useful lives of assets mentioned in Schedule II of the Companies Act, 2013. As statutory auditor of the company how would you deal with this? (4 Marks)

Answer

(a) Minimum Audit Fee: Prescribed minimum audit fee is recommendatory, not mandatory in nature. Therefore, acceptance of audit assignment by M/s ASKS, a firm of Chartered Accountants having 3 partners, of a private limited company for audit fees of rupees 4,000 is not violation of any provisions.

Therefore M/s ASKS will not be held liable for guilty of misconduct.

(b) Maintenance of Branch Office in the Same City: As per section 27 of the Chartered Accountants Act, 1949 if a chartered accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. However, a member can be in-charge of two offices if the second office is located in the same premises or in the same city, in which the first office is located; or the second office is located within a distance of 50 kilometers from the municipal limits of a city, in which the first office is located.

In the given case, Mr. K, Chartered Accountant in practice as a sole proprietor at Chennai has an office in suburbs of Chennai, and due to increase in the work he opened another branch within the city near the income tax office. He also employed a retired income tax commissioner to run the new office and the second office is situated within a distance of 30 kilometers from his office in the suburb.

In view of above provisions, there will be no misconduct if Mr. K will be in-charge of both the offices. However, he is bound to declare which of the two offices is the main office.

(c) Important Points to be kept In Mind While Drafting Letter of Weakness: As per SA 265, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management", the auditor shall include in the written communication of significant deficiencies in internal control -

(i) A description of the deficiencies and an explanation of their potential effects; and

(ii) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In other words the auditor should communicate material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows-

(1) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.

(2) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.

(3) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.

(4) The letter may also serve to minimize legal liability in the event of a major defalcation or other loss resulting from a weakness in internal control.

(d) Providing Depreciation ignoring Schedule II to the Companies Act, 2013: Section 129 of the Companies Act, 2013, requires that the financial statements shall give a true and fair view of the state of affairs of the company and are in compliance with Accounting Standards.

Further, as per Schedule II to the Companies Act, 2013 on 'Useful Lives to Compute Depreciation', the useful life of an asset shall not ordinarily be different from the useful life specified therein.

However, if such a company uses a useful life of the asset which is different from the above limits, it shall disclose the justification for the same in its financial statement.

In the given case, M/s IT Limited has mentioned in the significant accounting policies that the depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management and ignored the useful lives of the assets as provided under Schedule II to the Companies Act, 2013.

Therefore, the statutory auditor of the company should ensure that the management has disclosed the justification for consideration of different useful life of the assets from that as indicated under Schedule II. If the justification has not been provided then the auditor of the company shall suggest the management for the same and if management refuses, the auditor should qualify his report accordingly.

Question 6

(a) Mr. S, a practicing Chartered Accountant agreed to provide "Portfolio Management Services" to his client M/s. D Limited. Comment with reference to the Chartered Accountants Act, 1949. (4 Marks)

(b) AX Insurance Limited has made a provision of 75% of net premium in case of marine hull insurance and 50% in case of marine cargo and miscellaneous business of net premium for unexpired risks reserve in its books. Comment. *(4 Marks)*

(c) You are appointed as an auditor of Global Ltd. Explain the risk factors relating to misstatements arising from misappropriation of assets. *(4 Marks)*

(d) While compiling the accounts of Hope Ltd., you observed that a few accounting standards have not been followed and there have been omission of some information which was required to be followed in the current situation. How would you deal with this?

(4 Marks)

Answer

(a) **Advising on Portfolio Management Services:** The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, Mr. S would be guilty of misconduct under the Chartered Accountants Act, 1949.

(b) **Unexpired Risks Reserve:** The Insurance Laws (Amendment) Act, 2015 notified dated 20th March, 2015 has amended the Insurance Act, 1938, General Insurance Business (Nationalisation) Act, 1972 and Insurance Regulatory and Development Authority Act, 1999.

In view of changes made by Amendment Act, valuation of every item of liability of the insurer should be done in the manner as may be specified by the regulations made in this behalf. Therefore, assuming that there is no prescribed limit (till the time it is specified in regulations), both the provisions made by AX Insurance Limited is in order.

(c) **Risk Factors Relating to Misstatements Arising from Misappropriation of Assets:** As per SA 240, "The Auditor's Responsibilities Relating to Fraud in audit of Financial Statements", misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Risk factors that relate to misstatements arising from misappropriation of assets are classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. The following are examples of risk factors related to misstatements arising from misappropriation of assets:

Incentives/Pressures: Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

1. Known or anticipated future employee layoffs.
2. Recent or anticipated changes to employee compensation or benefit plans.
3. Promotions, compensation or other rewards inconsistent with expectations.

Opportunities: Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Inventory items that are small in size, of high value, or in high demand.
- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
- Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets.
- Inadequate segregation of duties or independent checks.

Attitudes/Rationalizations

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.

(d) Non-Compliance with the Accounting Standards: As per SRS 4410, "Engagements to Compile Financial Informations", in the case of a company, the financial statements compiled must comply with the relevant provisions of the Companies Act, including the Accounting Standards and, accordingly, give a true and fair view. However, without carrying out the procedures necessary for an audit, the accountant cannot form any opinion on whether the accounts give a true and fair view, even though he has compiled these financial statements.

The compilation is based on the information supplied to the accountant by the client and does not include any verification thereof. However, if the accountant becomes aware of material non-compliance with any applicable Accounting Standard(s), the same should be brought to the attention of the management and, if the same is not rectified by the management, it should be included in the Notes to the Accounts and the compilation report of the accountant.

Thus, for not following and omission of some information which was required to be followed in the current situation for Hope Ltd., we should bring this matter to the attention of the management for rectification and, if the same is not rectified by the management, we should include the same in the Notes to the Accounts and the compilation report of the accountant.

Question 7

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

(a) Gross exposure margin and Volatility margin.

(b) Permanent Consolidated Adjustments.

(c) Aspects to be covered in the books of accounts to be maintained by a multi-state co-operative society.

(d) Matters addressed in Clause 49 regarding Corporate Governance.

(e) Obligation of the statutory auditor to report frauds to the Central Government during the audit carried out under the Companies Act, 2013. *(4 x 4 = 16)*

Answer

(a) **Gross Exposure Margin:** Gross exposure margin is computed on the aggregate of the net cumulative outstanding positions (purchases or sales) in each security. Each Exchange determines its own rates of Gross Exposure Margin and Additional Volatility Margin based on its own risk perception of the market and other risk containment measures such as deposits and collaterals in its possession.

Volatility Margin: Volatility margin is imposed to curb excessive volatility in the market and to act as a deterrent to building up of excessive outstanding positions. Price variations on account of calls, bonuses, rights, mergers, amalgamations and schemes of arrangements are adjusted for determining volatile securities and adjustments in prices is made for the purpose of computation of volatility, when securities are traded ex-benefits. Securities that attract volatility margin and the applicable margin rates are announced on the last day of the trading cycle and are applicable from the first day of the succeeding trading cycle. The volatility margin is levied on the net outstanding positions of the member, in each security, based on the respective margin rates.

(b) Permanent Consolidated Adjustments: Permanent consolidation adjustments are those adjustments that are made only on the first occasion of the preparation and presentation of consolidated financial statements. Permanent consolidation adjustments are:

(i) determination of excess or deficit of the cost to the parent of its investment in a subsidiary over the parent's portion of equity of subsidiary, at the date on which investment in the subsidiary is made;

(ii) determination of the amount of equity attributable to minorities at the date on which investment in subsidiary is made;

(iii) determination of goodwill or capital reserve arising on application of equity method to account for investments in associates in consolidated financial statements.

(c) Aspects to be covered in the Books of Accounts to be maintained by a Multi-State Co-operative Society: As per Multi-State Co-Operative Society Rules 2002, every Multi-State co-operative society shall keep books of account with respect to-

(i) all sum of money received and expended and matters in respect of which the receipt and expenditure take place;

(ii) all sale and purchase of goods;

(iii) the assets and liabilities;

(iv) in the case of a Multi-State co-operative society engaged in production, processing and manufacturing, particulars relating to utilization of materials or labour or other items of cost as may be specified in the bye-laws of such a society.

(d) Matters addressed in Clause 49 regarding Corporate Governance: Matters addressed in Clause 49 regarding Corporate Governance are -

(i) Board's Director including its composition and compensation;

(ii) Provisions regarding Board's Committee including composition and functioning of Audit Committee which is an important pillar of the Corporate Governance;

(iii) Management of subsidiary companies;

(iv) Disclosures of important issues regarding related party transactions accounting policies, principle of risk management, accounting for proceeds from public issues, right issues, preferential issues, etc;

(v) Content of management discussion and analysis;

(vi) Information to shareholders;

(vii) CEO/ CFO certification;

(viii) Report of Corporate Governance and compliance certificate.

(e) **Obligation of the Statutory Auditor to report frauds to the Central Government during the audit carried out under the Companies Act, 2013**: As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner prescribed in Companies (Audit and Auditors) Rules, 2014.

Companies (Audit and Auditors) Rules, 2014, prescribes that in case the auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company, he shall report the matter to the Central Government immediately but not later than 60 days of his knowledge and after following the procedure indicated herein below:

(i) auditor shall forward his report to the Board or the Audit Committee, as the case may be, immediately after he comes to knowledge of the fraud, seeking their reply or observations within 45 days;

(ii) on receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days of receipt of such reply or observations;

(iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he failed to receive any reply or observations within the stipulated time.