

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any **five** from the rest

Question 1

- (a) It was observed from the modified audit report of the financial statements of AS Ltd. for the year ended 31st March, 2017 that depreciation of ₹ 2.50 crore for the year 2016-2017 had been charged off to the Statement of Profit and Loss instead of including it in "carrying value of asset under construction". State in relation to the audit for the year ended 31st March 2018, whether such modification in the previous year's audit report would have any audit implication for the current year and if yes, how would you deal with it in your audit report? **(5 Marks)**
- (b) Your firm has been appointed as an Independent Auditor to carry out "Review of Interim Financial Information" of GK Ltd. You would like to apply analytical procedures in the course of Review. Give examples of analytical procedures you may consider when performing a Review of Interim Financial Information as per SRE 2410. **(5 Marks)**
- (c) Your firm is one of the Joint Auditors of FMP Ltd. Under what circumstances joint auditors are jointly liable for the work in relation to audit of financial statements? Is there any restriction on a joint auditor to communicate a dissenting note differing from the majority opinion of the other joint auditors in the audit report issued under Section 143 of the Companies Act 2013? **(5 Marks)**
- (d) The financial statements of MP Ltd. as on March 31, 2018 are to be prepared under Division II of Schedule III to the Companies Act, 2013. Comment on the disclosure compliances for MP Ltd. from the following information in the financial statements which are required to be drawn up in compliance with Ind AS.
- (i) Property, Plant and Equipment include ₹ 2.50 crore for a boiler-plant under construction.
 - (ii) Cash and cash equivalents include ₹ 1.25 crore deposited with a nationalized bank on 31st March, 2018 for 18 months. It is shown under current assets.
 - (iii) Non-current assets include under caption "Biological assets other than bearer Plants" a sum of ₹ 1.50 crore being cost of cultivation for bringing to yield level, the cashewnut trees whose yield period, according to estimate shall not be less than 10 years.
 - (iv) In the Statement of Profit and Loss, the charge due to re-measurement of defined benefit plans of employees is shown in Employee Benefit Expenses.
 - (v) In the Statement of Profit and Loss, proposed dividend is shown under finance cost. **(5 Marks)**

Answer

- (a) **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:

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

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 AS Ltd. does not correct the treatment of depreciation extent of rupees 2.50 crore for previous year, the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the figures and provisions are corrected, the auditor need not refer to the earlier year's modification.

- (b) **Examples of Analytical Procedures the Auditor May Consider When Performing a Review of Interim Financial Information:** As per SRE 2410, examples of analytical procedures the auditor may consider when performing a review of interim financial information include the following:

- Comparing the interim financial information with the interim financial information of the immediately preceding interim period, with the interim financial information of the corresponding interim period of the preceding financial year, with the interim financial information that was expected by management for the current period, and with the most recent audited annual financial statements.
- Comparing current interim financial information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes to pretax income in the current interim financial information with corresponding information in (a) budgets, using expected rates, and (b) financial information for prior periods).

- Comparing current interim financial information with relevant non-financial information.
 - Comparing the recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and applying relationships that are reasonably expected to exist based on the auditor's understanding of the entity and of the industry in which the entity operates.
 - Comparing ratios and indicators for the current interim period with those of entities in the same industry.
 - Comparing relationships among elements in the current interim financial information with corresponding relationships in the interim financial information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.
 - Comparing disaggregated data. The following are examples of how data may be disaggregated:
 - ◆ By period, for example, revenue or expense items disaggregated into quarterly, monthly, or weekly amounts.
 - ◆ By product line or source of revenue.
 - ◆ By location, for example, by component.
 - ◆ By attributes of the transaction, for example, revenue generated by designers, architects, or craftsmen.
 - ◆ By several attributes of the transaction, for example, sales by product and month.
- (c) **Circumstances in which Joint Auditors are Jointly Liable: SA 299, "Responsibility of Joint Auditors,"** prescribes in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him.

On the other hand, all the joint auditors are jointly and severally responsible –

- (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. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

- (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.

Restriction on a Joint Auditor to Communicate a Dissenting note differing from Majority opinion of other Joint Auditors in the Audit Report: 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 his own opinion through a separate report. A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

- (d) (i) **Disclosure of Boiler Plant under Construction:** Boiler plant under construction should be shown under the heading Capital Work in Progress instead of Property Plant and Equipment. Thus, inclusion of value of boiler plant under construction in Property Plant and Equipment is not in order.
- (ii) **Disclosure of Cash and Cash Equivalents deposited with Nationalised Bank:** Bank deposits with more than 12 months maturity shall be disclosed under 'Other financial assets'. Therefore, disclosure of deposits rupees 1.25 crores in a nationalised bank for 18 month as Cash and Cash Equivalents is not in order as per Division II of Schedule III.
- (iii) **Disclosure of Cost of Cultivation for bringing to yield level the Cashewnut trees:** Cost of 1.5 crore rupees for Cultivation for bringing to yield level, the cashewnut trees whose yield period is more than one period will form part of 'Bearer Plant'. Hence it will not be considered as 'Biological Assets other than bearer plant'. Therefore, it should be shown under the heading Property Plant and Equipment as Bearer Plant as per Division II of Schedule III.
- (iv) **Disclosure of Re-measurement of defined benefit plans of Employees:** As per Ind AS 19 Employee Benefits, the charge due to re-measurement of defined benefit plans of employees should be recognised in Other Comprehensive Income. Therefore, charge due to re-measurement of defined benefit plans of employees shown in the Statement of Profit and Loss is not in compliance in with Division II of Schedule III.
- (v) **Proposed Dividend:** As per Ind AS 10 Events after the Reporting Period, Proposed dividend is an event after the reporting period, therefore, would not form part of Financial Statements of current period.

Question 2

- (a) *What is meant by "Group financial statements"? Give reference of relevant Auditing Standard and issues addressed concerning the audit of Group financial statements.*
(4 Marks)
- (b) *State the nature of liability as provided in the Companies Act, 2013 of an auditor for not appropriately dealing with a misstatement appearing in audited financial statements or a false statement in Audit Report.*
(4 Marks)
- (c) *List out the key differences between "Reasonable Assurance" and "Limited Assurance" engagements.*
(4 Marks)
- (d) *What are the reporting requirements in the audit report under the Companies Act, 2013 / CARO, 2016 for the following situations?*
- (i) *A fraud has been committed against the company by an officer of the company.*
 - (ii) *A fraud has been committed against the company by a vendor of the company.*
 - (iii) *The company has committed a major fraud on its customer and the case is pending in the court.*
 - (iv) *A fraud has been reported in the cost audit report but not noticed by statutory auditor in his audit.*
(4 Marks)

Answer

- (a) **Meaning of Group Financial Statements:** Financial statements that include the financial information of more than one component. The term "group financial statements" also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

Issues addressed concerning the audit of Group Financial Statements: Where the statutory auditors of one or more of the components of the parent are also requested to assist the principal auditor, the work to be performed by such statutory auditors for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory audit of the respective component.

Standard on Auditing (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.

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with

regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

- The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.
- The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the concept of materiality would not be considered.

Thus, the component auditor's observations, if any, on the component's financial statements, irrespective of whether the auditors of the component are also the auditors of the CFS or not, are required to be included in the parent auditor's report on the CFS, regardless of materiality.

- (b) **Nature of Liability as per the Companies Act, 2013:-** Under section 448 of the Companies Act, 2013, an auditor is liable for criminal prosecution, if he, in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, makes a statement (a) which is false in any material particular knowing it to be false; or (b) which omits any material fact knowing it to be material.

If convicted, he can be punished with imprisonment and also with fine as provided under section 447 of the said Act.

Thus, in view of above, an auditor will be held liable for criminal prosecution for not appropriately dealing with a misstatement appearing in audited financial statements or a false statement in Audit Report assuming that it was known to auditor.

- (c) **Key Difference between Reasonable Assurance Engagement and Limited Assurance Engagements :**

Type of Engagement	Objective	Evidence-gathering procedures	The Assurance Report
Reasonable Assurance Engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the	<ul style="list-style-type: none"> ➤ Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: ➤ Obtaining an understanding of the engagement circumstances; 	Description of the engagement circumstances and a positive form of expression of the

	engagement as the basis for a positive form of expression of the practitioner's conclusion	<ul style="list-style-type: none"> ➤ Assessing risks; ➤ Responding to assessed risks; ➤ Performing further procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and inquiry. Such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and ➤ Evaluating the evidence obtained 	conclusion
Limited Assurance Engagement	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to reasonable assurance engagement	Description of the engagement circumstances, and a negative form of expression of the conclusion

(d) **Reporting Requirements in the Audit Report under the Companies Act, 2013 / CARO 2016:** According to Clause (x) of Para 3 of CARO 2016, the auditor is required to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the auditor is required to state the amount involved and the nature of fraud.

Further, **as per section 143(12) 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 (in case amount of fraud is rupees 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than rupees 1 crore) within such time and in such manner as may be prescribed.

- (i) **Fraud Committed against the Company by an Officer of the Company:** Fraud committed against the company by an officer of the company has to be reported in accordance with Clause (x) of Para 3 of CARO 2016, and as per section 143(12) of the Companies Act, 2013.
- (ii) **Fraud committed against the company by a vendor of the Company:** In case employees or management are involved in fraud committed by vendor, reporting has to be done in accordance with CARO 2016 and as per section 143 (12) of the Companies Act, 2013. Suspected fraud by vendors, customers and other third parties should be dealt with in accordance with SA 240. Therefore, reporting has to be done in accordance with SA 240, "The Auditor's Responsibilities relating to Fraud in an audit of Financial Statements".
- (iii) **Company has committed major fraud on its customer of which case is pending in the court:** Major fraud committed by the company on its customer has to be reported in accordance with Clause (x) of Para 3 of CARO 2016.
- (iv) **Fraud reported in Cost Audit Report but not noticed by Statutory Auditor:** As per Clause (x) of Para 3 of CARO 2016, all frauds noticed or reported during the year shall be reported indicating the nature and amount involved as specified the fraud by the company or on the company by its officers or employees are only covered.

Here in the given scenario, a fraud has been reported in the cost audit report but not noticed by Statutory Auditor in his audit. Hence the statutory auditor has to report the nature and amount involved in the audit report as per section 143 of the Companies Act, 2013.

Question 3

- (a) *As a Company auditor you notice that there is an inter-corporate loan granted by the company. What are the reporting requirements as regards the matters concerning terms of interest on the intercorporate loan?* **(4 Marks)**
- (b) *Comment on the following in the light of certificate of compliance of conditions of Corporate Governance to be issued for a listed company where the Board consists of 10 directors including a non-executive director as its chairman and further:*
 - (i) *There were 5 meetings held during the year as follows 01/04/2017, 01/06/2017, 01/09/2017, 03/01/2018, 25/03/2018.*

- (ii) *There are 4 independent directors. One of them resigned on 25/05/2017. A new independent director was appointed on 01/09/2017.*
- (iii) *The Chairman of Audit Committee did not attend the Annual General meeting held on 14/09/2017.*
- (iv) *The internal audit reports were obtained by Audit Committee on quarterly basis. Quarter 1 internal audit report commented on certain serious irregularities as regards electronic online auction of scrap. The agenda of Audit Committee did not deliberate or take note of the issue. (4 Marks)*
- (c) *CA. Amar has come across certain key matters while auditing the accounts of PR Ltd. for the financial year 2017-18. He, being the associate of your firm, seeks your advice on "Communicating Key Audit Matters" in the Auditor's Report. Guide him. (5 Marks)*
- (d) *Explain how 'Test Data' is used as an audit technique to test specific controls in Computer programs. (3 Marks)*

Answer

- (a) **Reporting Requirements for terms of Interest on the Intercorporate loan:** As per clause (iv) of Para 3 of CARO, 2016, the auditor is required to report in respect of loans, investments, guarantees, and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with. If not, provide the details thereof.

For this purpose, the auditor should obtain the details of, loans given to any person or other body corporate, guarantee given or security provided in connection with a loan to any other body corporate or person and securities acquired of any other body corporate by way of subscription, purchase or otherwise, made during the year as well as the outstanding balances as at the beginning of the year in accordance with section 186.

As per Clause (iv) of CARO, 2016, with respect to matters concerning terms of interest on the intercorporate loan the auditor is required to:

- (i) Check whether rate of interest is not lower than the prevailing yield of one year, three year, five year or ten year government security closest to the tenor of the loan granted.
- (ii) Check if the company is in default in the repayment of any deposits accepted or in payment of interest thereon, then the company is not allowed to give any loan or guarantee or any security or an acquisition till such default is subsisting.

Non-compliance with respect to interest on the intercorporate loan may be reported incorporating following details:-

S. No.	Non-compliance of Section 186			Remarks, if any
	Name of Company/ Party	Amount Involved	Balance as at Balance Sheet Date	
	Loan given at rate of interest lower than prescribed			
	Any other default			

- (b) **Compliance of conditions of Corporate Governance in case of Listed Company:** As per Listing Obligation and Disclosure Requirements Regulations 2015, depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of corporate governance for example:
- (i) The Audit Committee shall meet at least four times in a year and not more than one hundred and twenty days shall lapse between two meetings. The number of days between the meetings held on 1.9.2017 and 3.01.2018 is more than 120 days. Hence it is a non-compliance and would require qualification in certificate of corporate governance
 - (ii) Since the Chairman is the non-executive director, there should be 1/3rd of directors (rounded to next integer) to be independent. In this case, 4 directors need to be independent. Any vacancy during shortfall of independent directorship should be filled within next 3 months or before the start of next meeting, whichever is later. In the instant case, since the independent director was appointed after lapse of 3 months (i.e. on 1.9.2017) and after next first meeting 1/6/2017, there is default which would require qualification in certificate on corporate governance.
 - (iii) Chairman shall be present at Annual General Meeting to answer shareholder queries. In the given scenario, Chairman of Audit Committee did not attend the Annual General Meeting held on 14/09/2017 which is not in order/compliance.
 - (iv) The Audit Committee shall mandatorily review the Internal audit reports relating to internal control weaknesses as per Part C (B) of Schedule II and the auditor should ascertain from the minutes book of the Audit Committee and other sources like agenda papers, etc. whether the Audit Committee has reviewed the above-mentioned information. In the given situation, the agenda of Audit Committee did not deliberate or take note of serious irregularity mention in Internal Audit Report which is again not in compliance of conditions of Corporate Governance and warrant audit qualification in certificate on corporate governance.

(c) **Communicating Key Audit Matters in the Auditor's Report:** The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:

- (i) Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- (ii) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

The description of each key audit matter in the Key Audit Matters section of the auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

- (i) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter; and
- (ii) How the matter was addressed in the audit.

The auditor shall describe each key audit matter in the auditor's report unless:

- (i) Law or regulation precludes public disclosure about the matter; or
- (ii) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter.

(d) **Test Data:**

- (i) Test data is used to test specific controls in computer programmes, such as online password and data access controls.
- (ii) Examples of such uses are:
 - (i) Test transactions selected from previously processed transactions or created by the auditor to test specific processing characteristics of an entity's computer system. Such transactions are generally processed separately from the entity's normal processing.
 - (ii) Test transactions in an integrated test facility where a "dummy" unit (e.g., a department or employee) is established and to which test transactions are posted during the normal processing cycle.

- (iii) When test data is processed with the entity's normal processing, the auditor should ensure that the test transactions are subsequently eliminated from the entity's accounting records.

Question 4

- (a) Comment on the validity of the appointment of Mr. A as an auditor of ABC Ltd. in the following situations

- (i) Mr. B, a partner of Mr. A held shares of face value of ₹ 1,00,000 in DEF Ltd., the holding company of., ABC Ltd. Mr. B has sold the securities after a period of 45 days from the date of appointment of Mr. A as an auditor of ABC Ltd.
- (ii) Mrs. A, wife of Mr. A had given a financial guarantee for the principal amount of a debt owed by Mr. X to ABC Ltd. for ₹ 6 lakhs. Mr. X has repaid ₹ 5 lakhs to ABC Ltd. 2 days before the date of appointment of Mr. A as an auditor of the company.

(3 + 3 = 6 Marks)

- (b) Explain the terms:

- (i) 'Internal Financial Control' and
- (ii) 'Internal Financial Controls over Financial Reporting' **(3 + 3 = 6 Marks)**

- (c) In the course of audit of PB Ltd., you observe that there is a likelihood of misstatement in the account balances and disclosures in the financial statements. What should be your considerations as an auditor for "Assessing the Risk of Material Misstatements"?

(4 Marks)

Answer

- (a) (i) **Validity of appointment of Auditor:** According to section 141(3)(d)(i) of the companies act 2013, a person is disqualified to be appointed as auditor of the company if he or his relative or partner holds securities in the company or its holding company or subsidiary company, associate company or the subsidiary of the holding company.

Rule 10 of the Companies (Audit and Auditors) rule 2014 permits relative alone to hold shares in the company up to 1 Lakh. It also provides a time limit of 60 days to correct the situation where disqualification would otherwise incur

As such when a partner holds securities in holding company of the company in which Mr. A is to be appointed as auditor, there is disqualification for Mr. A to be appointed as auditor. Subsequent disposal is of no relevance.

- (ii) **Guarantee by the relative of Auditor:** Section 141 (3)(d)(iii) of the Companies Act 2013 provides that a person is disqualified to be appointed as auditor of the company if he or his relative or partner has given guarantee or provided security to any 3rd

person for his indebtedness with the company, its holding company, its subsidiary, associate company or subsidiary of its holding company for an amount the limit prescribed.

Rule 10 of the Companies (Audit and Auditors) Rule 2014 prescribes a limit of amount that exceeds ₹ 1 Lakh. As such, any guarantee or provision of security for an amount exceeding 1 Lakh will render a person to be disqualified

In the present case, at the time of appointment, the guarantee subsists only for the remaining ₹ 1 Lakh as ₹ 5 lakhs out of ₹ 6 Lakhs has been already discharged, no disqualification is attracted.

(b) (i) **Internal Financial Control:** As per Section 134 of the Companies Act 2013, the term Internal Financial Controls means the policies and procedures adopted by the company for ensuring:

- Orderly and efficient conduct of its business, including adherence to Company's policies,
- Safeguarding of its assets,
- Prevention and detection of frauds and errors,
- Accuracy and completeness of the accounting records, and
- Timely preparation of reliable financial information.

(ii) **Internal Financial Control over Financial Reporting:** As per Guidance Note issued by ICAI on Guidance Note on Audit of Internal Financial Controls Over Financial Reporting, "Internal Financial Controls Over Financial Reporting (ICFR) shall mean:

"A Process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles". A Company's internal financial control over financial reporting includes those policies and procedures:

Pertain to the maintenance of the records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company:

It provides reasonable assurance that transactions are recorded as necessary to permit preparation of financial statement in accordance with generally accepted accounting principles, and those receipts and expenditures of the company are being made only in accordance with authorizations of management and director of the company.

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effects of the financial statement.

- (c) **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.

Question 5

- (a) *Your firm has been appointed as Statutory Branch auditor of a Nationalised Bank for the financial year 2017-18 which is dealing in Nostro accounts. Enumerate the audit procedures you will follow for verification of Nostro accounts. (4 Marks)*
- (b) *What are the audit procedures to be undertaken while verifying the "Contract notes" of a Stock Broker? (4 Marks)*
- (c) *You are the auditor of MP Ltd., a NBFC registered with RBI as an Investment Company. How would you proceed to ensure the "Compliance of Prudential Norms Directions" by MP Ltd.? (4 Marks)*
- (d) *You are the Tax Auditor of BL & Co., a partnership firm engaged in the business of plying of Goods Carriages for the financial year 2017-18 having a turnover of ₹ 20 crores. How would you deal and report on the following:*
 - (i) *Payment of ₹ 50,000 in cash to Mr. R on 10th September, 2017 towards settlement of invoice for expenses accounted in financial year 2016-17.*
 - (ii) *Payment of 3 invoices of ₹ 15,000 each made in cash to Mr. Y on 8th, 9th, 10th July, 2017 respectively. (4 Marks)*

Answer

- (a) **Audit Procedures for verification of Nostro Accounts:** Bank's maintain stocks of foreign currencies in the form of Bank Accounts with their overseas branches/correspondents.

Such foreign currency accounts maintained by Indian banks at other overseas centres are designated by it as “Nostro Account”.

While examining the transaction in foreign exchange, the auditor should also pay attention to:

- (i) Borrowings from abroad by banks in India needs to be considered as ‘liabilities to other’ and thus, needs to be considered at gross level unlike ‘liabilities towards banking system in India’, which are permitted to be netted off against ‘assets towards banking system in India’. Thus, the adverse balances in Nostro Mirror Account needs to be considered as ‘Liabilities to other’
 - (ii) The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.
 - (iii) Unreconciled Nostro accounts, on examination may reveal unauthorized payments from the foreign currency account, unauthorized withdrawals and unauthorized debit to mirror account.
 - (iv) The auditor shall also evaluate the internal control with regard to inward/outward messages. The inward/ outward messages should be properly authenticated and discrepancies noticed, should be properly dealt with in the books of accounts
- (b) Contract Notes:** Contract note is a document through which a contractual obligation is established between a member and a client. The auditor should evaluate the internal control procedures instituted by the stock broker for proper maintenance and issuance of contract notes. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the clients. The auditor should verify the list of trades executed with the bills raised. The auditor should apply appropriate audit procedures to satisfy himself that -
- (i) Contract notes have been serially numbered.
 - (ii) No serial number has been left blank.
 - (iii) Format of the Contract Note is as prescribed by the Regulations of the Exchange.
 - (iv) Duplicate copies / counterfoils of contract notes are maintained.
 - (v) Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.
 - (vi) Contract notes have been signed by an authorised person.
 - (vii) Contract notes have been issued in respect of all transactions.

- (viii) Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.
- (ix) SEBI Registration number, Settlement number, Settlement dates have been mentioned.
- (x) PAN number of the member and client has been mentioned on Contract Note where if required.
- (xi) All clauses specified by the Exchange have been printed on the reverse of the contract notes.

(c) Compliance of Prudential Norms by NBFC:

- (i) The auditor has to verify the compliance of prudential norms relating to (1) income recognition; (2) Income from investments; (3) Asset classification; (4) Provision for bad and doubtful debts; (5) Capital adequacy norm; (6) Prohibition of granting loans against its own shares; (7) Prohibition on loans and investments for failure to repay public deposits and (8) Norms for concentration of credit etc.
- (ii) In case of Investment Company, 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) The auditor shall ensure that Board of the NBFC shall frame a policy for granting demand/call loans and implement the same.
- (iv) The auditor should verify the classification of advances and loans as standard/substandard/doubtful/loss and that proper provision has been made in accordance with the directions.
- (v) Auditor should ensure that unrealised income from non-performing assets has not been taken to Statement of Profit and Loss.
- (vi) The auditor should check all NPAs of the previous years to verify whether during the current year any payments have been received or still they continue to be NPA during the current year also.
- (vii) NBFC prudential norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis.
- (viii) 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.

- (d) **Reporting of Payments Exceeding rupees 35,000 in Cash:** 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 rupees 10,000. However, in case of payment made for plying, hiring or leasing of goods carriage, limit is rupees 35,000 instead of rupees 10,000.

Further, as per section 40A(3A) of the Income Tax Act, 1961, where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments made to a person in a day, exceeds rupees 10,000 (rupees 35,000 in case of plying, hiring or leasing of goods carriages).

Therefore, as per the provisions and explanations discussed above, the given cases (on the basis of assumption that payment is made towards plying, hiring or leasing of goods carriages) are dealt as under-

- i. Payment of rupees 50,000 made in cash (which is in excess of ₹ 35,000) to Mr. R on 10th September 2017 towards settlement of an invoice for expenses accounted in financial year 2016-17 is likely to be deemed to be the profits and gains of business or profession under section 40A(3A) of the Income Tax Act, 1961. Thus, the details of such amount need to be furnished under clause 21(d)(B) of Form 3CD.
- ii. Payments of 3 invoices of rupees 15,000 each made in cash on 8th, 9th July, 2017 and 10th July, 2017 respectively aggregating rupees 45,000 need not be reported as the payment does not exceed rupees 35,000 in a day.

Question 6

Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto:

- (a) *D, a practising Chartered Accountant examined and reported on the prospective financial statements for one of his clients to obtain a cash credit facility of ₹75 lakhs from a Private Bank. The Bank has sanctioned the cash credit facility for ₹ 60 lakhs to his client. Consequent to the sanction of loan by Bank, he charged a fees of ₹ 60, 000 based on 1% of the credit facility sanctioned.* **(4 Marks)**
- (b) *R, a practising Chartered Accountant, is a Director in X Ltd; a Public Company. The prospectus of X Ltd. mentions the name of Mr. R as a director along with his various professional attainments, his areas of specialization and expertise in the field of international taxation.* **(4 Marks)**

- (c) *J, a practising Chartered Accountant has not maintained the record of audit assignments of the companies on the ground that he is conducting lesser number of audits prescribed under Section 141 (3) (g) of the Companies Act, 2013. (4 Marks)*
- (d) *ENI Ltd; a company registered under the Companies Act, 2013 has created a separate Trust "ENI Employees Gratuity Fund Trust". Both the Company and Trust are under the same management. Mr. A is the auditor of both the entities. Mr. A has observed that some part of the expenditure was not applied towards the objects of the Trust. He informed the matter to the Board of Trustees through a separate report but did not qualify the Audit Report of the Trust. (4 Marks)*

Answer

- (a) **Charging of Fees based on Percentage:** Clause (10) of Part I to First Schedule to the Chartered Accountants Act prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him. However, this restriction is not applicable where such payment is permitted by the Chartered Accountants Act, 1949.

The Council of the Institute has framed regulation 192 which exempts certain professional services from the operation of Clause (10). In the case of certain fund raising services, the fees may be based on a percentage of the fund raised.

In the present situation, CA. D examined and report on the prospective financial statements to obtain a cash credit facility from a private bank. Consequent to sanction of loan by bank, he charged 1% of credit facility sanctioned as his fees.

The services rendered by CA D are not covered under the said exemption.

CA D is liable for professional misconduct as he has charged fees at 1% on the credit facilities sanctioned, which is prohibited under clause 10 of Part I of 1st schedule to CA Act 1949.

- (b) **Description of expertise and specialisation in Prospectus of Public Company:** The Council of the ICAI has in a communication to members stated that if a public company, in which a chartered accountant in practice is a director, issues a prospectus or gives any announcement that gives descriptions about the Chartered Accountant's expertise, specialisation and knowledge in any particular field, it shall constitute a misconduct under Clauses (6) and (7) of Part I of the First Schedule to the Chartered Accountants Act, 1949.

The Council has further stated that in such cases the member concerned has to take necessary steps to ensure that such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the members.

In the present scenario, prospectus of X Ltd. Mention the name of Mr. R as a director along with his various professional attainments, his areas of specialization and expertise in the

field of international taxation.

Thus, in the instant case, Mr. R would be held to be guilty of professional misconduct under clauses (6) and (7) of Part 1 of 1st schedule of the Chartered Accountants Act 1949.

- (c) **Record of Audit Assignments:** In exercise of the powers conferred by Chapter VIII of Council General Guidelines 2008, the Council of the Institute of Chartered Accountants of India specified that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies as per the Companies Act.

As a part of this clause, to meet its requirements, a Chartered Accountants in practice as well as a firm in practice shall maintain a record of the audit assignments accepted as laid out in guidelines issued by the Council of the ICAI under Part II of Second Schedule to the Chartered Accountants Act, 1949 in respect of ceiling on audits containing following particulars:

S. No.	Name of the Company	Registration Number	Date of appointment	Date of Acceptance	Date on which Prescribed Form filed with Registrar of Companies
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In the instant case, Mr. J, a practising Chartered Accountant has not maintained the record of audit assignment of the Companies on the ground that he is conducting lesser number of audits prescribed under section 141 (3)(g) of the Companies Act, 2013 is not in accordance with Chapter VIII of Central Council Guidelines 2008.

Hence, Mr. J is guilty of professional misconduct under Part II of 2nd schedule of Chartered Accountants Act 1949 as he has contravened the guidelines issued by the council.

- (d) **Disclosure of Material Facts:** A Chartered Accountant in practice is deemed to be guilty of professional misconduct under Clause (5) of Part I of the Second Schedule if he "fails to disclose a material fact known to him which is not disclosed in a financial statement but disclosure of which is necessary to make the financial statement not misleading".

In this case, the Chartered Accountant was aware of some part of the expenses not applied towards the object i.e. contraventions and irregularities committed by the trust as these were referred to in the separate report given by the Chartered Accountant to the Board of Trustees of the company.

However, he issued audit report without any qualification which is not in order.

Therefore, CA A is deemed to be guilty of professional misconduct.

Question 7

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

- (a) True and Fair Cost of Production

- (b) *Issues addressed in Performance Audit of PSUs*
- (c) *Audit versus Investigation*
- (d) *Management Audit Questionnaire*
- (e) *Scope of Peer Review*

(4 x 4 = 16 Marks)

Answer

- (a) **True and Fair Cost of Production:** A cost auditor checks the cost accounting records to verify that the cost statements are properly drawn up as per the records and that they present a true and fair view of the cost of production and marketing of various products dealt with by the undertaking. The Companies (cost records and audit) Rules, 2014, prescribe the rules regarding the cost audit report and also prescribes the classes of companies required to include cost records in their books of account, applicability of cost audit, maintenance of records etc. The prescribed format of the report contains assertions regarding whether cost accounting records have been properly kept so as to give a true and fair view of the cost of production/ etc. The provisions of sub-section (12) of section 143 of the Companies Act, 2013 and the relevant rules on duty to report on fraud shall apply mutatis mutandis to a cost auditor during performance of his functions under section 148 of the Act and these rules. In any case, the true and fair concept is known to us in the context of financial accounts. Based on that knowledge, it may be assumed that the following are the relevant considerations in determining whether the cost of production determined is true and fair:
- (i) Determination of cost following the generally accepted cost accounting principles.
 - (ii) Application of the costing system appropriate to the product.
 - (iii) Materiality.
 - (iv) Consistency in the application of costing system and cost accounting principles.
 - (v) Maintenance of cost records and preparation of cost statements in the prescribed form and having the prescribed contents.
 - (vi) Elimination of material prior-period adjustments.
 - (vii) Abnormal wastes and losses and other unusual transactions being ignored in determination of cost.

(b) **Issues Addressed in Performance Audit:**

Performance Audit: An objective and systematic examination of evidences for the purpose of providing an independent assessment of the performance of a government organization, program, activity or function in order to provide information to improve public accountability and facilitate decision making by parties with responsibility to oversee or initiate corrective action. It is conducted by C&AG. Performance Audit addresses the following issues:

- (i) **Economy-** It is minimising the cost of resources used for an activity, having regard to appropriate quantity, quality and at the best price whether given resources have been used economically.
- (ii) **Efficiency-** It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximized at minimum inputs or input is minimized for any given quantity and quality of output
- (iii) **Effectiveness-** It is the extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.
- (c) **Audit versus Investigation:** Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific.

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non- statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.

(vi) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind capable of observing, collecting and evaluating facts.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
(vii) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

(d) Management Audit Questionnaire:

- i. A management audit questionnaire is an important tool for conducting the management audit.
- ii. It is through these questionnaires that the auditors make an inquiry into important facts by measuring current performance.
- iii. Such questionnaires aim at a comprehensive and constructive examination of an organisation's management and its assigned tasks.
- iv. Overall it is concerned with the appraisal of management actions in accomplishing the organisation's objectives.
- v. Its primary objective is to highlight weaknesses and deficiencies of the organisation.
- vi. There are three possible answers to the management audit questions: "Yes", "No" and "N.A.", (not applicable).
- vii. Questionnaire comments on negative answers not only provide documentation for future reference, but, more important, provide background information for undertaking remedial action.
- viii. Thus, management audit questionnaire for this part of the audit not only serves as a management tool to analyse the current situation; more importantly, it enables the management auditors to synthesise those elements that are causing organisational difficulties and deficiencies.

(e) Scope of peer review: The Statement on Peer Review lays down the scope of review to be conducted as under:

The Peer Review process shall apply to all the assurance services provided by a Practice Unit.

1. Once a Practice Unit is selected for Review, its assurance engagement records pertaining to the Peer Review Period shall be subjected to Review.
2. The Review shall cover:
 - (i) Compliance with Technical, Professional and Ethical Standards:
 - (ii) Quality of reporting.

- (iii) Systems and procedures for carrying out assurance services.
- (iv) Training programmes for staff (including articled and audit assistants) concerned with assurance functions, including availability of appropriate infrastructure.
- (v) Compliance with directions and/or guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.
- (vi) Compliance with directions and/or guidelines issued by the Council in relation to articled assistants and/or audit assistants, including attendance register, work diaries, stipend payments, and such other related records.