PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

*Question No. **1** is compulsory*

*Answer any **four** from the rest*

Question 1

(a) *Mr. L while conducting the audit of ABC Ltd., observed that a substantial amount is recognized in respect of obsolescence of inventory and warranty obligation in the financial statements. Mr. L wants to obtain written representation from the management to determine whether the assumptions and estimates used are reasonable. Guide Mr. L with reference to the relevant Standard on Auditing.* ***(5 Marks)***

(b) *LMP Associates, Chartered Accountants, conducting the audit of PQR Ltd., a listed Company for the year ended 31st March 2019 is concerned with the auditor's responsibilities relating to other information, both financial and non-financial, included in the Company's annual report. While reading other information, LMP Associates considers whether there is a material inconsistency between other information and the financial statements. As a basis for the consideration the auditor shall evaluate their consistency, compare selected amounts or other items in the other information with such amounts or other items in the financial statements. Guide LMP Associates with examples of "Amounts" or "other items" that may be included in the "other information" with reference to SA 720.* ***(5 Marks)***

(c) *MB & Associates is a partnership firm of Chartered Accountants which was established seven years back. The firm is getting new clients and has also, been offered new engagement services with existing clients. The firm is concerned about obtaining such information as it considers necessary in the circumstances before accepting an engagement with a new client and acceptance of a new engagement with an existing client. The firm is looking to work with only select clients to adhere to the Quality Control Standards. Guide MB & Associates about the matters to be considered with regard to the integrity of a client, as per the requirements of SQC 1.* ***(4 Marks)***

Answer

(a) **Written Representations:** As per **SA 540, "**Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures**"**, the auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

SA 580, "Written Representations" discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

(i) About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

(ii) That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.

(iii) That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.

(iv) That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

(b) Examples of Amounts or Other Items that May Be Included in the Other Information: As per SA **720 "The Auditor's Responsibility in Relation to Other Information**", the following are examples of amounts and other items that may be included in other information. This list is not intended to be exhaustive.

Amounts

(i) Items in a summary of key financial results, such as net income, earnings per share, dividends, sales and other operating revenues, and purchases and operating expenses.

(ii) Selected operating data, such as income from continuing operations by major operating area, or sales by geographical segment or product line.

(iii) Special items, such as asset dispositions, litigation provisions, asset impairments, tax adjustments, environmental remediation provisions, and restructuring and reorganization expenses.

(iv) Liquidity and capital resource information, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations.

(v) Capital expenditures by segment or division.

(vi) Amounts involved in, and related financial effects of, off-balance sheet arrangements.

(vii) Amounts involved in guarantees, contractual obligations, legal or environmental claims, and other contingencies.

(viii) Financial measures or ratios, such as gross margin, return on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and debt ratio. Some of these may be directly reconcilable to the financial statements.

Other Items

(i) Explanations of critical accounting estimates and related assumptions.

(ii) Identification of related parties and descriptions of transactions with them.

(iii) Articulation of the entity's policies or approach to manage commodity, foreign exchange or interest rate risks, such as through the use of forward contracts, interest rate swaps, or other financial instruments.

(iv) Descriptions of the nature of off-balance sheet arrangements.

(v) Descriptions of guarantees, indemnifications, contractual obligations, litigation or environmental liability cases, and other contingencies, including management's qualitative assessments of the entity's related exposures.

(vi) Descriptions of changes in legal or regulatory requirements, such as new tax or environmental regulations, that have materially impacted the entity's operations or fiscal position, or will have a material impact on the entity's future financial prospects.

(vii) Management's qualitative assessments of the impacts of new financial reporting standards that have come into effect during the period, or will come into effect in the following period, on the entity's financial results, financial position and cash flows.

(viii) General descriptions of the business environment and outlook.

(ix) Overview of strategy.

(x) Descriptions of trends in market prices of key commodities or raw materials.

(xi) Contrasts of supply, demand and regulatory circumstances between geographic regions.

(xii) Explanations of specific factors influencing the entity's profitability in specific segments.

(c) As per **SQC 1,** the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

(i) The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.

(ii) The nature of the client's operations, including its business practices.

(iii) Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.

(iv) Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.

(v) Indications of an inappropriate limitation in the scope of work.

(vi) Indications that the client might be involved in money laundering or other criminal activities.

(vii) The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

Question 2

(a) The Entity's Risk Assessment Process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of occurrence and decides upon actions to respond to and manage them and the results thereof. Elucidate the circumstances in which risks can arise or change.

(5 Marks)

(b) CA. G, was appointed by DP Ltd., as Statutory Auditor. While doing the audit of DP Ltd., CA. G observed that certain loans and advances were made without proper securities; certain trade receivables and trade payables were adjusted inter se; and personal expenses were charged to revenue. As a company auditor comment on the, reporting responsibilities of CA. G. ***(5 Marks)***

(c) Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto: A special notice has been issued for a resolution at 3rd annual general meeting of LED Ltd., providing expressly that CA. Anoop shall not be re-appointed as an auditor of the· company. Consequently, CA. Anoop submitted a representation in writing to the company with a request to circulate to the members. In the detailed representation, CA. Anoop included the contributions made by him in strengthening the control procedures of the company during his association with the company and also indicated his willingness to continue as an auditor if reappointed by the shareholders of the company. ***(4 Marks)***

Answer

(a) Entity's Risk Assessment Process: Risks can arise or change due to circumstances such as the following-

(i) **Changes in operating environment**: Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

(ii) **New personnel**: New personnel may have a different focus on or understanding of internal control.

(iii) **New or revamped information systems:** Significant and rapid changes in information systems can change the risk relating to internal control.

(iv) **Rapid growth**: Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

(v) **New technology**: Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

(vi) **New business models, products, or activities**: Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.

(vii) **Corporate restructurings**: Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.

(viii) **Expanded foreign operations**: The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.

(ix) **New accounting pronouncements**: Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

(b) Duty of Auditor to Inquire on certain matters: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) of the Companies Act, 2013 is worth considering and reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)."

Clause (a) of Section 143(1) requires the auditor to inquire: "Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members".

If the auditor finds that the **loans and advances** have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule III to the Companies Act. Further the auditor to inquire whether or not the terms on which the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If **trade receivables and trade payables** are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire "whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company". This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards".

Regarding **Personal Expenses**, Clause (e) of section 143(1) requires the auditor to inquire: "Whether personal expenses have been charged to revenue account". The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

(c) Soliciting Clients: As per **Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949,** a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means except applying or requesting for or inviting or securing professional work from another chartered accountant in practice and responding to tenders.

Further**, section 140(4)(iii) of the Companies Act, 2013**, provides a right, to the retiring auditor, to make representation in writing to the company. The retiring auditor has the right for his representation to be circulated among the members of the company and to be read out at the meeting. However, the content of letter should be set out in a dignified manner how he has been acting independently and conscientiously through the term of his office and may, in addition, indicate, if he so chooses, his willingness to continue as auditor, if re- appointed by the shareholders.

The proposition of the auditor to highlight contributions made by him in strengthening the control procedures in the representation should not be included in such representations because the representation letter should not be prepared in a manner so as to seek publicity.

Thus, highlighting contributions made by him in strengthening the control procedures, while submitting representation U/S 140(4)(iii) of the Companies Act 2013, would amount to canvassing or soliciting for his continuance as auditor.

Therefore, **CA. Anoop will be held guilty for professional misconduct** under Clause (6) of Part I of First Schedule to the Chartered Accountants Act, 1949.

Question 3

(a) As an auditor of a company registered under section 8 of the Companies Act, 2013, you find that as per the notification of the Ministry of Corporate Affairs regarding applicability of Indian According Standards (Ind-AS), the company has to prepare its financial statements for the year ended 31st March, 2019 under Ind-AS. The management of the company is, however, of the strong view that being a section 8 company having charitable objects, Ind-AS cannot apply to the company. The financial statements are, therefore, prepared by the management under the earlier GAAP and a note for the same is given in the financial statements. How would you report on these financial statements? ***(5 Marks)***

(b) Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. Its other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises.

Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are, therefore, required to draw an audit programme initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points relating to a complex. ***(5 Marks)***

(c) In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. You are required to briefly explain the relevant considerations for every phase in above audit approach in case of an automated environment. ***(4 Marks)***

Answer 3

(a) Applicability of IND AS: Section 129(1) of the Companies Act, 2013, governs the requirements to be satisfied by financial statements. The provisions thereunder which should be complied with are:

- financial statements shall, give a true and fair view of the state of affairs of the company or companies as at the end of financial year, comply with the notified accounting standards under section 133 and be in such form or forms specified in Schedule III to the Companies Act, 2013 and
- the items contained in such financial statements shall be in accordance with the accounting standards.

Further, as per **section 133 of the Companies Act, 2013**, the Central Government has notified **Companies (Indian Accounting Standards) Rules, 2015 dated 16.02.2015** in exercise of the powers conferred by section 133. The said rules list the Indian Accounting Standards (Ind AS) and the class of companies required to comply with the Ind AS while preparation of their financial statements.

Here, it may be noted that the companies covered under Section 8 are required to comply the provisions of the Companies Act, 2013, unless and until any exemption is provided. Therefore, **companies registered under Section 8 are not exempted from the requirements of section 133 and section 129 of the Companies Act, 2013.**

In the given case, only contention of management that being a section 8 company having charitable object, Ind-AS cannot apply to the company, therefore financial statements prepared under the earlier GAAP and a note for the same is given, is not tenable.

However, **the auditor is required to ensure the applicable monetary limits w.r.t Ind-AS** and need to advise the management to prepare the financial statements as per Ind-AS accordingly. In case of non-compliance the auditor should report accordingly.

(b) Audit Programme of Movie Theatre Complex:

(i) Peruse the Memorandum of Association and Articles of Association of the entity.

(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:

(1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.

(2) Verify the system of relating to online booking of various shows and the system of realization of money.

(3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.

(iv) Verify the **internal control system** and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.

(v) Verify the system of control exercised relating to the **income receivable from advertisements** exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

(vi) Verify the system of collection from the **parking areas** in respect of the vehicles parked by the customers.

(vii) In the case of **payment to the distributors** verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.

(viii) Verify the system **of payment of salaries and other benefits to the employees** and ensure that statutory requirements are complied with.

(ix) Verify the payments effected in respect of the **maintenance of the building** and ensure the same is in order.

(x) Verify the insurance premium paid and ensure it covers the entire assets.

(c) In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. In this approach, the considerations of automated environment will be relevant at every phase as given below:

(i) during risk assessment, the auditor should consider **risk arising from the use of IT systems** at the company;

(ii) when obtaining an understanding of the business process and **performing walkthroughs** the use of IT systems and applications should be considered;

(iii) while assessing the entity level controls the aspects related to **IT governance** need to be understood and reviewed;

(iv) pervasive controls including **segregation of duties**, general IT controls and applications should be considered and reviewed;

(v) during **testing phase**, the results of general IT controls would impact the nature, timing and extent of testing;

(vi) when testing of reports and information produced by the entity (IPE) generated through **IT systems and applications;**

(vii) at **completion stage,** evaluation of control deficiencies may require using data analytics and CAATs.

Alternative Answer

(c) In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. In this approach, the considerations of automated environment will be relevant at every phase as given below:

I. Risk Assessment Process

- Identify significant accounts and disclosures.
- Qualitative and Quantitative considerations.
- Relevant Financial Statement Assertions (FSA).
- Identify likely sources of misstatement.
- Consider risk arising from use of IT systems.

II. Understand and Evaluate

- Document understanding of business processes using Flowcharts / Narratives.

- Prepare Risk and Control Matrices (RCM).
- Understand design of controls by performing walkthrough of end-to-end process.
- Process wide considerations for Entity Level Controls, Segregation of Duties.
- IT General Controls, Application Controls.

III. Test for Operating Effectiveness

- Assess Nature, Timing and Extent (NTE) of controls testing.
- Assess reliability of source data; completeness of population.
- Testing of key reports and spreadsheets.
- Sample testing.
- Consider competence and independence of staff /team performing controls testing.

IV. Reporting

- Evaluate Control Deficiencies.
- Significant deficiencies, Material weaknesses.
- Remediation of control weaknesses.
- Internal Controls Memo (ICM) or Management Letter.
- Auditor's report.

Question 4

(a) Mr. G. has been appointed as an auditor of LMP Ltd., a NBFC company registered with RBI. Mr. G is concerned about whether the format of financial statements prepared by LMP Ltd. is as per notification issued by the Ministry of Corporate Affairs (MCA) dated October 11, 2018. The notification prescribed the· format in Division III under Schedule III of the Companies Act, 2013 applicable to NBFCs complying with Ind-AS. Mr. G wants to know the differences in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Help Mr. G. ***(5 Marks)***

(b) You have been appointed as an auditor of LCO Bank, a nationalized bank. LCO Bank also deals in providing credit card facilities to its account holder. The bank is aware of the fact that there should be strict control over storage and issue of credit cards. How will you evaluate the Internal Control System in the area of Credit Card operations of a Bank?

(5 Marks)

(c) Mr. PK is conducting the Tax audit under section 44 AB of the Income Tax Act, 1961 of MG Ltd. for the year ended 31st March 2019. There is a difference of opinion between Mr. PK and the Management in respect of certain information to be furnished in Form No. 3CD. As a tax auditor, Mr. PK has to report whether the statement of particulars in Form 3CD

are true and correct and the same is to be annexed to the report in Form No. 3CA. Advise on the matters to be considered by Mr. PK while furnishing the particulars in Form No. 3CD. ***(4 Marks)***

Answer

(a) Differences between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III –The Ministry of Corporate Affairs (MCA) vide notification dated October 11, 2018 introduced Division III under Schedule III of the Companies Act, 2013, wherein a format for preparation of financial statements by NBFCs complying with Ind- AS has been prescribed.

The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

(i) NBFCs have been allowed to present the items of the balance sheet in **order of their liquidity** which is not allowed to companies required to follow Division II.

(ii) Additionally, NBFCs are required to classify items of the balance sheet into **financial and non-financial** whereas other companies are required to classify the items into **current and non-current**.

(iii) An NBFC is required to separately disclose by way of **a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income**. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds **1 per cent of the revenue from operations or . 10 lakhs, whichever is higher.**

(iv) NBFCs are required to separately disclose under **'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.**

(v) NBFCs are also required to disclose items comprising **'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of as part of the notes.**

(b) Evaluation of the Internal Control System in the area of Credit Card Operations of a bank:

(i) There should be **effective screening** of applications with reasonably good credit assessments.

(ii) There should be strict control over **storage and issue of cards**.

(iii) There should be a system whereby a merchant confirms the status of **unutilised limit of a credit-**card holder from the bank before accepting the settlement in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

(iv) There should be a system of **prompt reporting** by the merchants of all settlements accepted by them through credit cards.

(v) **Reimbursement to merchants** should be made only after verification of the validity of merchant's acceptance of cards.

(vi) All the **reimbursement (gross of commission**) should be immediately charged to the customer's account.

(vii) There should be a system to ensure that **statements are sent regularly and promp**tly to the customer.

(viii) There should be a system to **monitor and follow-up customers' payments**.

(ix) **Items overdue** beyond a reasonable period should be identified and attended to carefully. Credit should be stopped by informing the merchants through **periodic bulletins**, as early as possible, to avoid increased losses.

(x) There should be a system of **periodic review of credit card holders' accounts**. On this basis, the **limits of customers may be revised**, if necessary. The review should also include **determination of doubtful amounts and the provisioning in respect thereof**.

(c) The statement of particulars given in Form No. 3CD as annexure to the audit report contains forty-one clauses. The tax auditor has to report whether the particulars are true and correct. This Form is a statement of particulars required to be furnished under section 44AB. The same is to be annexed to the reports in Forms No. 3CA and 3CB in respect of a person who carries on business or profession and whose accounts have been audited under any other law and in respect of person who carries on business or profession but who is not required by or under any other law to get his accounts audited respectively.

While furnishing the particulars in Form No. 3CD it would be advisable for the tax auditor to consider the following:

(i) If a particular item of income/expenditure is **covered in more than one of the specified clauses** in the statement of particulars, care should be taken to make a **suitable cross reference** to such items at the appropriate places.

(ii) If there is any difference in the opinion of the tax auditor and that of the assessee in respect of any information furnished in Form No. 3CD, the **tax auditor should state both the view points** and also the relevant information in order to enable the tax authority to take a decision in the matter.

(iii) If any particular clause in Form No. 3CD is not applicable, he should state that the **same is not applicable.**

(iv) In computing the **allowance or disallowance, he should keep in view the law applicable** in the relevant year, even though the form of audit report may not have been amended to bring it in conformity with the amended law.

(v) In case the prescribed particulars are given in part or piecemeal to the tax auditor or relevant form is incomplete and the assessee does not give the information against all or any of the clauses, the **auditor should not withhold the entire audit report**. In such a case, he can **qualify his report** on matters in respect of which information is not furnished to him. In the absence of relevant information, the tax auditor would have no option but to state in his report that the relevant information has not been furnished by the assessee.

(vi) The information in Form No. 3CD should be **based on the books of accounts, records, documents, information and explanations** made available to the tax auditor for his examination.

(vii) In case the auditor relies on a **judicial pronouncement**, he may mention the fact as his observations in clause (3) of Form No. 3CA or clause (5) provided in Form No. 3CB, as the case may be.

Question 5

(a) Mr. 'K', a practicing Chartered Accountant is the proprietor of M/s K & Co. since 1995. He went abroad in the month of December 2018. He delegated the authority to Mr. 'Y' a Chartered Accountant, his employee for taking care of the important matters of his office. During his absence Mr. 'Y' has conducted the undermentioned jobs in the name of M/s K & Co.

(i) He issued Net worth certificate to a client for furnishing to a Bank.

(ii) He attended the GST proceedings for a client as authorized representative before GST Authorities.

Please comment on eligibility of Mr. 'Y' for conducting such jobs in name of M/s K & Co. and liability of Mr. 'K' under the Chartered Accountants Act, 1949. · ***(5 Marks)***

(b) D Ltd., a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India, the revenue of the company is going down and there is slowdown in other activities of the company. Therefore, it is expected that there would not be significant work for members of the Audit Committee.

Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet only once at the year end. They reviewed monthly information system of the Company and found no errors

As an auditor of D Limited, would you consider the decision taken by the Audit Committee to hold the meeting once in a year, in complying with Listing Obligation and Disclosure Requirements (LODR)? Also state the quorum requirements for such meetings. ***(5 Marks)***

(c) Mr. X has been appointed as an auditor of M/s ABC Ltd., Mr. X wants to be satisfied about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements. Lay down the audit procedure, Mr. X should follow, in the initial audit engagement of M/s ABC Ltd. Also suggest the approach to be followed regarding mention in the audit report if Mr. X is not satisfied about the correctness of 'Opening Balances'?

(4 Marks)

Answer

(a) **Delegation of Authority to the Employee:** As per **Clause (12) of Part I of the First Schedule of the Chartered Accountants Act, 1949**, a Chartered Accountant in practice is deemed to be guilty of professional misconduct "if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements".

In this case CA. 'K' proprietor of M/s K & Co., went abroad and delegated the authority to another Chartered Accountant Mr. Y, his employee, for taking care of the important matters of his office who is not a partner but a member of the Institute of Chartered Accountants of India.

The Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, asking for information or issue of questionnaire, attending to routing matters in tax practice, subject to provisions of Section 288 of Income Tax Act etc.

(i) In the given case, Mr. 'Y', a chartered accountant being employee of M/s K & Co. has **issued net worth certificate for furnishing to a bank**. Since the issuance of net worth certificate to a client by Mr. "Y" being an employee of M/s K& Co. (an audit firm), is **not a routine work and it is outside his authorities.** Thus, **CA. 'K' is guilty of professional misconduct** under Clause (12) of Part I of First Schedule of the Chartered Accountants Act, 1949.

(ii) Further, Mr. "Y", CA employee of the audit firm M/s K& Co. has **attended the GST proceedings** for a client as authorized representative before GST Authorities. Since the **council has allowed the delegation of such work**, the chartered accountant employee can attend to routine matter in tax practice as decided by the council. Therefore, there is **no misconduct in this case** as per Clause (12) of Part I of First schedule to the Act.

(b) **One of the following additional requirement as stipulated under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR Regulations") on which Section 177 of the Companies Act, 2013 (relating to audit committee) is silent is :** The Audit Committee should meet at least four times in a year and not more than one hundred and twenty days shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent directors present.

The Audit Committee shall mandatorily review the following information as per LODR Regulations:

(i) Management **discussion and analysis of financial condition and results of operations;**

(ii) Statement of **significant related party transactions** (as defined by the Audit Committee), submitted by management;

(iii) **Management letters** / letters of internal control weaknesses issued by the statutory auditors;

(iv) **Internal audit reports** relating to internal control weaknesses;

(v) The **appointment, removal and terms of remuneration of the Chief internal auditor** shall be subject to review by the Audit Committee; and

(vi) **Statement of deviations:** (a) quarterly statement of deviations including report of monitoring agency if applicable and (b) annual statement of funds utilized for purposes other than those stated in the offer document/ prospectus/ notice.

In the instant case, due to recessionary conditions, slowdown in activities of the company and not expecting the significant work for the members of the audit committee, D Ltd. decided unanimously to meet only once at the year end. They also reviewed monthly information system of the company and found no errors.

In view of above, **decision taken by the audit committee** to hold the meeting only once at the year end **is not correct** as the Audit Committee should meet at least four times in a year and not more than one hundred and twenty days shall elapse between two meetings.

Besides, there is a **mandatory review requirement** and to review only monthly information system is not sufficient. Here the audit committee members reviewed only monthly information system of the company and **the same is not sufficient as per LODR Regulations**.

(c) Audit Procedures to be followed in case of initial audit engagement: As per SA 510, the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(i) Determining whether the **prior period's closing balances** have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(ii) Determining whether the **opening balances reflect the application of appropriate accounting policies**; and

(iii) Performing one or more of the following:

(1) Where the prior year financial statements were audited, **perusing the copies of the audited financial statements** including the other relevant documents relating to the prior period financial statements;

(2) Evaluating whether **audit procedures performed** in the current period provide evidence relevant to the opening balances; or

(iv) Performing **specific audit procedures** to obtain evidence regarding the opening balances.

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

Question 6

(a) "The C & AG may direct the appointed auditor about the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India". What are the relevant sections of the Companies Act, 2013 and steps involved in the audit of Government Companies? ***(5 Marks)***

(b) Mr. 'C', a Chartered Accountant employed as Senior executive in charge of Tax in a company, and not holding certificate of practice recommends a particular lawyer to his employer in respect of a case. The lawyer, out of the professional fee received from the employer of Mr. 'C' paid a particular sum as referral fee to Mr. 'C'. Comment with reference to the Chartered Accountants Act, 1949 and schedules thereto. ***(5 Marks)***

(c) MF. Ltd., engaged in the manufacturing of various products in its factory, is concerned with shortage in production and there arose suspicion of inventory fraud. You are appointed by MF Ltd. To evaluate the options for verifying the process to reveal fraud and the corrective action to be taken. As an investigating accountant what will be your areas of verification and the procedure to be followed for verification of defalcation of inventory? ***(4 Marks)***

Answer

(a) The following steps are involved in the audit of government companies:

(i) Appointment of Auditors under Section 139(5) and 139(7) read with section 143(5) of the Companies Act, 2013 - Statutory auditors of Government Companies are appointed or re-appointed by the C&AG. There is thus, a departure from the practice in vogue in the case of private sector companies where appointment or re-appointment of the auditors and their remuneration are decided by the members at the annual general meetings. In the case of government companies, though the appointment of statutory auditors is done by the C&AG, the remuneration is left to the individual companies to decide based on certain guidelines given by the C&AG in this regard.

(ii) The C&AG may direct the appointed auditor on the manner in which the accounts of the Government company are required to be audited and the auditor so appointed has to submit a copy of the audit report to the Comptroller and Auditor-General of

India. The report, among other things, includes the directions, if any, issued by the C&AG, the action taken thereon and its impact on the accounts and financial statement of the company.

The report under section 143(5) is in addition to the reports issued by the Statutory Auditors under various other clauses of section 143.

(iii) **Supplementary audit under section 143(6)(a) of the Companies Act, 2013 -**The Comptroller and Auditor-General of India shall **within 60 days** from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statements of the government company by such person or persons as he may authorize in this behalf and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the C&AG may direct.

(iv) **Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013 -** Any comments given by the C&AG upon, or in supplement to, the audit report issued by the statutory auditors **shall be sent by the company to every person entitled** to copies of audited financial statements **under sub-section (1) of section 136** of the said Act i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be **placed before the annual general meeting of the company** at the same time and in the same manner as the audit report.

(v) **Test audit under section 143(7) of the Companies Act, 2013 -**Without prejudice to the provisions relating to audit and auditor, the C&AG may, in case of any company covered under **sub-section (5) or sub-section (7) of section 139** of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of **section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.**

(b) **Referral Fee from Lawyer:** According to **Clause (2) of Part II of First Schedule of the Chartered Accountant Act, 1949**, a member of the Institute(other than a member in practice) shall be guilty of professional misconduct, if he being an employee of any company, firm or person accepts or agrees to accept any part of fee, profits or gains from a lawyer, a chartered accountant or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

In the present case, Mr. C who **beside holding a certificate of practice, is also an employee** and by referring a lawyer to the company in respect of a case, he receives a particular sum as referral fee from the lawyer out of his professional fee.

Conclusion: Therefore, **Mr. C is guilty of professional misconduct** by virtue of Clause (2) of Part II of First schedule

(c) Inventory frauds - Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply **remove goods** from the premises.

(ii) Theft of goods may be concealed by **writing them off as damaged goods**, etc.

(iii) **Inventory records may be manipulated by employees** who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

Verification Procedure for Defalcation of inventory - Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and despatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of:

(a) a system of inventory control, and existence of detailed record of the movement of inventory, or

(b) availability of sufficient data from which such a record can be constructed.

The step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

Defalcations of inventory, sometimes, also are committed by the management, by **diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production**; similar defalcations of inventories and stores are covered up by **inflating quantities issued for production**. For detecting such shortages, the investigating accountant should take **assistance of an engineer**. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the **shortage in production has been inflated.**

In this regard, guidance can also be taken from **past records showing the extent of wastage in production** in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent.

The **per hour capacity of the machine** and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.