

PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

Question No. 1 is compulsory

Answer any five from the rest

Question 1

- (a) *Mr. Ram, an auditor, identified some events that cast significant doubt on the entity's ability to continue as a going concern. What are the additional procedures he should perform as per the related Standard on Auditing?* (5 Marks)
- (b) *Mr. Mohan, an auditor of KTEN Limited wants to use the work of an expert. With reference to the Standard on Auditing state the factors which suggest the need for detailed and written agreement between the auditor and the auditor's expert.* (5 Marks)
- (c) *With reference to the Standards on Auditing state the examples of accounting estimates that may have a high estimation uncertainty.* (5 Marks)
- (d) *Is it appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it? Discuss.* (5 Marks)

Answer

- (a) **Additional Audit Procedures When Events or Conditions Are Identified:** As per SA 570 "Going Concern", when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:
 - (i) When management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
 - (ii) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
 - (iii) When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action:
 - (1) Evaluating the reliability of the underlying data generated to prepare the forecast; and
 - (2) Determining whether there is adequate support for the assumptions underlying the forecast.
 - (iv) Considering whether any additional facts or information have become available since the date on which management made its assessment.

- (v) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.
- (b) As per SA 620, "Using the work of an Auditor's Expert", some of the matters may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:
- The auditor's expert will have access to sensitive or confidential entity information.
 - The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
 - Multi-jurisdictional legal or regulatory requirements apply.
 - The matter to which the auditor's expert's work relates is highly complex.
 - The auditor has not previously used work performed by that expert.
 - The greater the extent of the auditor's expert's work, and its significance in the context of the audit.
- (c) **Examples of Accounting Estimates that may have a High Estimation Uncertainty:** As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures", the auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.
- Examples of accounting estimates that may have high estimation uncertainty include the following:
- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
 - Accounting estimates that are not calculated using recognised measurement techniques.
 - Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
 - Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.
- (d) **Auditor to make Inquiries regarding Management's own Assessment of Risk of Fraud and Controls:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud

and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity.

In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud.

Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Question 2

- (a) *Discuss the relationship between overall audit strategy and audit plan.* (4 Marks)
- (b) *State the considerations on which effectiveness of an efficient system of internal check depends.* (4 Marks)
- (c) *Superior Limited wants to shift its accounting process from manual to electronic medium. Discuss the primary effect of such changes.* (4 Marks)
- (d) *While adopting the accounts for the year, the Board of Directors of Prima Ltd., decided to consider the Interim Dividend declared @ 12% as final dividend and did not consider transfer of profit to Reserves. As a statutory auditor, how would you deal with this?* (4 Marks)

Answer

(a) Relationship between the Overall Audit Strategy and the Audit Plan:

- The audit strategy provides the guidelines for developing the audit plan. It establishes the scope and conduct of the audit procedures and thereby works as basis for developing a detailed audit plan.
- Detailed audit plan would include the nature, timing and extent of the audit procedures to obtain sufficient appropriate audit evidence.
- The audit strategy is prepared before the audit plan.
- The audit plan contains more details than the overall audit strategy.

- Audit strategy and audit plan are inter-related because change in one would result into change in the other.
- (b) **Considerations for the effectiveness of a System of Internal Check:** The effectiveness of an efficient system of internal checks depends on the following considerations:
- (i) **Clarity of responsibility** – The responsibility of different persons engaged in various operations of business transactions should be properly identified. A well integrated organizational chart depicting the names of responsible persons associated with specific functions may help to fix up responsibility.
 - (ii) **Division of work** – The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person is complementary to the other. Then, it is suggested that rotation of different employees through various components of job should be effectively implemented.
 - (iii) **Standardization** – The entire process of accounting should be standardized by creating suitable policies commensurate with the nature of business, so as to strengthen the system of internal checks.
 - (iv) **Appraisal** – Periodic review should be made of the chain of operations and flow. Such process may be carried out by preparing an audit flow chart.
- (c) **Impact of Changes on Accounting Processes** (for shifting from Manual to Electronic Medium): The primary effect of changes on accounting process may be stated as under:
- (i) **Process of recording transactions** - The process of recording transaction undergoes a major change when accounting process are computerised under CIS environment, the order of recording transaction from basic document to prime books and finally to principal book may not be followed strictly in sequential from as is observed in manual system. In many cases all the three processes Prime book of Entry, Ledger, Final accounts (Balance Sheet and Profit and Loss Account) are carried on simultaneously.
 - (ii) **Form of accounting records** - Mechanisation often results in the abandonment in whole or in part of the primary records. Punch card installation or electronic data processor changes the form of both intermediate and ultimate records much more radically than manual records.
 - (iii) **Use of loose-leaf stationeries** - Bound hand written records as used in manual accounting processes are replaced by loose-leaf machine written records in electronic medium. In a computerised information system, magnetic tapes, floppy disks, diskettes, print-outs replace the traditional records. This necessarily require proper control over such records to prevent their unauthorised use, destruction or substitution.
 - (iv) **Use of accounting code** – In computerised information systems, alpha-numeric codes are extensively used to represent names and description. The accountants as

well as the Auditors have to get themselves familiarised with the use of such codes which initially may pose considerable problems in understanding the various transactions.

- (v) **Absence of link between transaction** – In a computerised information system environment, there may be an inadequacy or even total absence of cross-reference between the basic documents, primary records and the principal records. This creates special problems for the auditors. The auditors may find it difficult to trace a transaction from start to finish there by having a doubt in their mind as to loss of audit trails.
- (d) **Declaration of Dividend and Transfer to Reserve:** Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the Statement of Profit and Loss and out of profits of the financial year in which such interim dividend is sought to be declared. The amount of dividend including interim dividend should be deposited in a separate bank account within five days from the declaration of such dividend for the compliance of Section 123(4) of the said Act.

Since interim dividend is also a dividend, companies should provide for depreciation as required by Section 123 before declaration of interim dividend. However the first proviso to Section 123(1) provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profit for that financial year as it may consider appropriate to the reserves of the company irrespective of the size of the declared dividend i.e. the company is not mandatorily required to transfer the profit to the reserves, it is an option available to the company to transfer such percentage.

In the instant case, the Board has decided to pay interim dividend @12% of the paid-up capital. Assuming that the company has complied with the depreciation requirement, the interim / final dividend can be declared without transferring such percentage of its profits as it may consider appropriate to the reserves of the company.

Therefore, from the above facts and provisions, it may be concluded that Prima Ltd. is under no violation of law i.e. the company is free to transfer any amount of its profit to the reserves, without any compulsion or restriction, before declaration of any dividend.

Question 3

- (a) *An auditor observed a fraud committed by an employee of the company. State the manner and timing of reporting of the fraud by the auditor.* (4 Marks)
- (b) *CA Adroit was indebted to Infructuous (P) Limited for a sum of ₹ 6,00,000 as on April, 1 2015. However, CA Adroit having come to know that he might be appointed as auditor of the company, he squared up the amount on July 10, 2015. Later on, he was appointed as auditor of the company for the year ended March 31, 2016 at the Annual General Meeting held on July 16, 2015. Subsequently, one of the shareholders complains that the*

appointment of CA adroit as an auditor is invalid because he incurred disqualification under section 141 of the Companies Act, 2013. Comment. (4 Marks)

- (c) *The auditor of Mould Limited made an adverse statement in his certificate as the Audit Committee of the company did not meet four times a year. Discuss few circumstances which require an adverse or qualified statement in the auditor's certificate in respect of compliance of the requirements of Corporate Government.* (4 Marks)
- (d) *CARO 2016 has made several significant changes and has introduced many new reporting requirements vis-à-vis CARO 2015.*

In view of the above, describe the relevant clause relating to Nidhi Companies-compliance with net owned funds to deposit requirements and the relevant provisions.

What audit procedures are to be adopted for verification and reporting on the same?

(4 Marks)

Answer

- (a) **Fraud Committed by an Employee of the Company:** 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 statutory 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 audit committee (in case amount involved in is less than ₹ 1 crore) within 2 days of his knowledge and he shall report the matter specifying the Nature of Fraud with description, Approximate amount involved; and Parties involved.

Further, if the offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, the auditor shall report the matter to the Central Government.

The manner of reporting the matter to the Central Government is as follows:

- (i) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- (ii) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (iii) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

- (iv) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
 - (v) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
 - (vi) the report shall be in the form of a statement as specified in Form ADT-4.
- (b) **Indebtedness to the Company:** As per section 141(3)(d)(ii) of the Companies Act, 2013, a person who is indebted to the company for an amount exceeding ₹ 5,00,000 shall be disqualified to act as an auditor of such company and further under section 141(4) he shall vacate his office of auditor when he incurs this disqualification subsequent to his appointment.

However, where the person has liquidated his debt before the appointment date, there is no disqualification to be construed for such appointment.

In the given case, CA Adroit was indebted to Infructuous (P) Ltd. for a sum of ₹ 6,00,000 as on 01.04.2015. He was appointed as an auditor of the company for the year ended 31.03.2016 at the Annual General Meeting held on 16.07.2015. He also repaid the loan amount fully to the company on 10.7.2015 i.e. before the date of his appointment.

Hence, the appointment of CA Adroit as an auditor is valid and the shareholder's complaint is not acceptable.

- (c) **Circumstances which require an Adverse or Qualified Statement** - 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 e.g.,
- (i) The number of non-executive directors is less than 50% of the strength of Board of directors.
 - (ii) A qualified and independent audit committee is not set up.
 - (iii) The chairman of the audit committee is not an independent director.
 - (iv) The audit committee does not meet four times a year.
 - (v) The necessary powers in terms of Clause 49 III (D) of the Listing Agreement have not been vested by the Board in the audit committee.
 - (vi) The time gap between two Board meetings is more than one hundred and twenty days.
 - (vii) A director is a member of more than ten committees or act as Chairman of more than five committees across all companies in which he is a director.

- (viii) The information of quarterly results is neither put on the company's website nor sent in a form so as to enable the Stock Exchange on which the entity's securities are listed to enable such Stock Exchange to put it on its own website.
- (ix) The power of share transfer is not delegated to an officer or a committee or to the registrar and share transfer agents.
- (d) **Deposits of Nidhi Companies:** The clause for reporting regarding compliance of deposit terms for Nidhi Company has been newly inserted in CARO 2016.

As per clause xii of Paragraph 3 of CARO 2016, the auditor is required to report that whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability.

The auditor should verify the computation of the deposit liability and net-owned funds on the basis of the specified requirements. In addition he should also verify the :

- (i) unencumbered term deposits of not less than ten per cent of the outstanding deposits; and
- (ii) ratio of net owned funds to deposits, of not more than 1:20.

In case it does not fulfil the criteria, the auditor is required to report in accordance with clause xii of paragraph 3 of the CARO 2016.

Question 4

- (a) *B Ltd is the Subsidiary company of A Ltd. ABC & Associates has been appointed as auditor of A Ltd. for the Financial Year 2014-15 and XYZ & Associates has been appointed as auditor of B Ltd for the year 2014-15. Explain the role of ABC & Associates and XYZ & Associates as auditors of the parent company and subsidiary respectively.*
(4 Marks)
- (b) *In order to check and prevent the diversion of funds in case of non-corporate borrowers, the lending bank sometimes obtains special report from the auditor on quarterly basis. Describe the details to be given in special report in respect of –*
 - (i) Operating data
 - (ii) Inventory
 - (iii) Information in respect of other items
(4 Marks)
- (c) *What are the obligations of auditor to submit Exception Report to RBI in case of non-banking financial companies?*
(4 Marks)
- (d) *Under which circumstances can the Central Government appoint the special auditor of a multi State Cooperative Society?*
(4 Marks)

Answer

- (a) **Role of Auditor in case of Parent Company and Subsidiary Company:** As per SA 600 "Using the Work of Another Auditor", there should be sufficient liaison between the principal auditor (hereinafter referred as auditor of Parent Company and the other auditor (hereinafter referred as auditor of Subsidiary Company).

Role of Principal Auditor (ABC & Associates- Auditor of Parent Company):

- (i) It is necessary to issue written communication(s) as a principal auditor to the other auditor.
- (ii) The principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.
- (iii) When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties.

Role of Other Auditor (XYZ & Associates- Auditor of Subsidiary Company):

- (i) The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc.
 - (ii) He should ensure compliance with the relevant statutory requirements.
 - (iii) The other auditor should respond to the questionnaire on a timely basis sent by Principal Auditor.
- (b) **Special Audit Report:** A lending bank may, in special cases, require the non-corporate entity to obtain a special report from the auditor. Such a report can be called by a lending bank if it finds that it is necessary to have more information about the working of the entity. In such a case the report will have to be given by the auditor on a quarterly basis. The special audit report which is to be given on a quarterly basis in the specified form is in addition to the normal audit report which is to be given by the auditor on a yearly basis.

Special Report in respect of Operating Data: In the quarterly special audit report, the auditor will have to give information relating to the operating data for each quarter. This information will have to be classified in the following manner:

- (i) Actual production;
- (ii) Actual production as a percentage of rated capacity;
- (iii) Sales;
- (iv) Cost of goods sold/cost of production;
- (v) Gross margin;

- (vi) Interest on bank borrowing; and
- (vii) Interest on others

Special Report in respect of Inventory: The age-wise classification of raw materials and finished goods is to be given. For this purpose age-wise classification is to be made in the following manner in respect of raw materials and finished goods separately;

- (i) Inventory for more than one year;
- (ii) Between 6 months and one year;
- (iii) Between three months and 6 months; and
- (iv) Below 3 months.

Similar information about the work-in-progress i.e. the number of days of production which remains in progress should also be given.

The basis of valuation of raw material and finished goods should be given. For this purpose, the following information is to be given:

- (i) The manner of determination of cost (i.e. components of cost)
- (ii) The method of valuing stock i.e. FIFO, weighted average cost, etc.

It is also necessary to state if there is any discrepancy between the quantity and value of the stock as furnished to the bank and as appearing in the books. The reasons for such discrepancy should be given in the audit report.

Special Report in respect of Other Items: Age-wise classification of bills receivable and other receivables with reference to the, bills due from domestic parties and bills in respect of exports should be given. The age-wise classification is to be done on the same basis as the classification for raw materials and finished goods as stated above.

Information in respect of the following items is also to be given:

- (i) Balances at the end of each month of the quarter for major categories of stock, receivables and bills receivables;
- (ii) Tax assessments and payments made during the quarter;
- (iii) Actual disbursement of capital expenditure during the quarter;
- (iv) Outstanding contracts on capital account at the end of the quarter giving the details about the names of parties and amounts outstanding;
- (v) The contingent liability which may or may not materialize during the financial year succeeding the relevant quarter;
- (vi) Investment made during the quarter and the income from such investments including profit on sale of investments;
- (vii) Loans given during the quarter;

- (viii) Loans raised during the quarter from banks and from others. Separate figures to be given;
- (ix) Overdue statutory liability at the end of the quarter;
- (x) Amounts due but not paid at the end of the quarter in respect of (a) loans from banks, (b) public deposits, and (c) other loans; and
- (xi) Figures of cash losses during the last 2 years to be stated on the basis of the annual accounts. If such accounts were not audited this fact should be stated.

The funds obtained from the lending banks have to be utilised for the purpose for which they are given by the bank. If the auditor finds that these funds have been diverted for the purposes other than those for which they were given by the bank the auditor will have to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give the details of the diversion for such other purposes.

In order that the lending bank may be able to ascertain the correct financial position and financial health of the entity it is necessary for the auditor to give information about the following ratios:

- (a) Current ratio
 - (b) Acid test ratio
 - (c) Raw materials-turnover ratio
 - (d) Finished goods-turnover ratio
 - (e) Receivables-turnover ratio
 - (f) Return on investment
 - (g) Interest cover ratio
 - (h) Net margin ratio
 - (i) Capital turnover ratio
 - (j) Debt equity ratio
 - (k) Operating cash flow.
- (c) **Obligation of Auditor to Submit an Exception Report to the Bank**
- (I) Where, in the case of a non-banking financial company, the statement regarding any of the matters to be included in the auditor's report is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:
 - (i) the provisions of Chapter III B of Reserve Bank of India Act, 1934; or

- (ii) the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998; or
- (iii) Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007; or
- (iv) Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998.

- (II) The duty of the Auditor under above stated paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (I) and such report shall not contain any statement with respect to compliance of any of those provisions.
- (d) Power of Central Government to direct special audit in certain cases: As per the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:
 - (i) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual aid and co-operative principles or prudent commercial practices or with sound business principles; or
 - (ii) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
 - (iii) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

The central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order, shall be conducted and appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit. However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society.

Question 5

- (a) *Explain the difference between the Proportional Treaties and Non Proportional Treaties?*

(4 Marks)

- (b) *While conducting audit of a member of stock exchange, what records/ documents are to be checked by the auditor with respect of transactions of dematerialized securities?*

(4 Marks)

- (c) *What are the relevant sections of the Companies Act, 2013 and steps involved in auditor of Government Companies?*

(4 Marks)

- (d) *The Central Government is of the view that there are certain interested members and companies who are financially interested in the success or failure of the company or who have been able to control or to materially influence the policy of the company.*

Hence the Central Government wants to investigate the ownership of the company.

Describe the scope and extent of investigation by an Investigator/ Chartered Accountant on behalf of Central Government under Companies Act, 2013.

(4 Marks)

Answer

- (a) **Difference between Proportional Treaties and Non Proportional Treaties:**

Proportional Treaties –

- (i) Proportional treaties are based on pro-rata apportionment of the sum insured, premium and losses, according to a pre-determined percentage/ratio.
- (ii) These treaties can be further classified as Quota Share Treaty, Surplus Treaty, Auto-Fac Treaty and pools.

Non-Proportional Treaties –

- (i) Non-Proportional treaties are characterised by a distribution of liability between the ceding company and the reinsurer on the basis of losses rather than the sum insured, as is the case in proportional reinsurance.
- (ii) Non-Proportional Treaties can be further classified into Excess of Loss Treaties, Excess of Loss Cover on Prevent basis, Excess of Loss cover on Non-Prevent basis, Stop Loss Treaties.

- (b) **Records or Documents to be checked for transactions of Dematerialized Securities:**

On account of compulsory dematerialisation of most of the securities listed on the Exchange, all stock brokers are required to maintain two accounts with their Depository Participants (DP) for handling the receipt and delivery of securities in demat.

- One account is 'Beneficiary Account' wherein the demat securities belonging to the members' for their own account are held and
- the other is 'Pool Account' wherein the demat securities of the clients are temporarily lodged for transfer to/from the Clients / Clearing House in the Pay-in/Pay-out.

In case of sale of securities by clients, the clients transfer the same in the demat form to the member's Pool Account to the Clearing House on the Pay-in day.

In case of purchase of securities by the Client, the Clearing House transfers the securities to the Pool Accounts of the members and the members then transfer the same to the accounts of individual clients.

The members are required to maintain a proper record of all shares received and delivered from their Pool Account as well as preserve acknowledged copy of the delivery instructions given to their DP's for transferring the securities from the Pool Account to the Clients' account after the Pay-out.

The auditor should verify whether the securities received by the member in the Pool Account are regularly transferred to the buying clients' Demat Accounts within 24 hours of declaration of Pay-out of the relevant settlement of the Exchange.

The auditor should check that the shares lying in the Pool Account have not been utilized by the member to meet his own pay-in obligations or used for meeting auction obligations.

- (c) Relevant Sections and Steps involved in Audit of Government Companies: Section 143(5), 143(6) and 143(7) of the Companies Act, 2013 are relevant sections in case of Audit of Government Companies.

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 Company are appointed or re-appointed by the Comptroller and Auditor General of India.

The C&AG may direct the appointed auditor 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 which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

- (ii) 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 statement of the 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 Comptroller and Auditor-General of India may direct.

- (iii) Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013 - Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report 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.

- (iv) Test audit under section 143(7) of the Companies Act, 2013 - Without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor- General of India 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 the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.
- (d) Scope and extent of investigation - When a chartered accountant is appointed to carry out an investigation, the extent of enquiry, the objective of the investigation and the various matters referred to for investigation are specified in the order of investigation issued by the appointing authority. On a consideration thereof, the investigating accountant should determine the areas of accounts which require investigation and the extent to which the enquiry is to be made as well as his general approach to the enquiry. For example, if the allegation is that certain transactions have been entered into in contravention of the provisions of the Companies Act, the nature of transactions, the persons who were parties thereto, the amount or amounts involved and the circumstances under which these were entered into must be examined. If the loss suffered by the company has given rise to a gain by a director and other managerial personnel or its associates, the manner in which the benefit has accrued and the amount thereof shall have to be investigated.

In case of a company having subsidiaries or where one or more directors are interested in one or more concerns, all the dealings with these concerns should be examined for these may have been entered into with the intention of transferring profit. Generally, all sales and purchases of goods and assets from directors and their associated concerns should be scrutinised since these also can be a vehicle of illicit transferring of profits.

Any breach of duty or abdication of responsibility for purposes of investigation would be material only if it has resulted in a loss to the company. In such a case, the factors responsible for the loss or losses, besides the amount thereof, shall have to be investigated. Negligence would be culpable only if it was in relation to a duty cast by the Act, Articles of Association or by a resolution of the shareholders or that of the Board of Directors.

Any negligence in the discharge of duty of a director or any other managerial personnel must be construed very broadly, for apart from being the agents of the company, they are trustees of its property.

It may be necessary for an investigator to interrogate directors, officers, agents, and others concerned with matters under his enquiry. Before drawing up his brief in this regard as well as for framing his conclusions, he should, if necessary, take legal assistance. If the Investigating accountant is required to report on the efficiency of the management, he

should be discreet in expressing his opinion. Usually, it is sufficient if he merely indicates the general limitations of the management. The inspector must ensure that the persons who figure in the investigation get the fullest opportunity to explain their action and conduct.

Question 6

- (a) *A Chartered Accountant is liable for disciplinary action under section 21 of CA Act, 1949, if he is found guilty of any professional or other misconduct.*

Explain the meaning of other misconduct with the help of two illustrative examples.

(4 Marks)

- (b) *A member of the institute shall not accept in a year more than the specified number of tax audits under section 44AB of the Income Tax Act.*

Mr. Gaurav is a partner in M/s. XYZ & Co., a firm of Chartered Accountants with 6 partners.

During the assessment year 2015-16, Mr. Gaurav alone had signed 290 tax audit reports consisting of both corporate and non-corporate assesses.

(4 Marks)

- (c) *Mr. Z accepted the statutory audit of a sick unit-NCT Limited for the year ending 31-3-2015. During course of audit it was noticed by the statutory auditor that company's net worth was negative for year ended 31-3-2014 and there was also a liability of tax audit fees of ₹ 35000 in favour of the previous auditor. Comment.*

(4 Marks)

- (d) *What are the fundamental principles as per code of ethics of ICAI? What are the threats involved while complying with the fundamental principles?*

(4 Marks)

Answer

- (a) **Other Misconduct:**

- (i) As per Part IV of First Schedule of the CA Act, a member of the Institute whether in practice or not, shall be deemed to be guilty of other misconduct if he-

1. Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months.
2. In the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action, whether or not related to his professional work.

- (ii) As per Part III of Second Schedule to the CA Act, a member of the Institute whether in practice or not shall be deemed to be guilty of other misconduct if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.

This provision empowers the Council to enquire any misconduct of a member even if it does not arise of professional misconduct.

Some illustrative examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are:

- (i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
 - (ii) Where a chartered accountant makes a material misrepresentation.
 - (iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.
 - (iv) Conviction by a competent court of law for any offence under Section 8(v) of the Chartered Accountants Act 1949.
 - (v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.
 - (vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.
 - (vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed-room of the chartered accountant.
 - (viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.
- (b) **Ceiling limit for signing the Tax Audit Reports:** As per Council General Guidelines 2008, a member of the Institute in practice shall not accept, in a financial year, more than the “specified number of tax audit assignments” under Section 44AB of the Income-tax Act, 1961. It is also provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the “specified number of tax audit assignments” in the aggregate.

In the case of firm of Chartered Accountants in practice “the specified number of tax audit assignments” means, 60 tax audit assignments per partner in the firm, in a financial year, whether in respect of corporate or non-corporate assesses.

Further, as per clarification issued by the Institute on Tax Audit Assignments, tax audit reports may be signed by the partners in any manner whosoever in accordance with specified audit limits. Thus, one partner can individually sign all the tax audit reports subject to specified tax audit assignment limits on behalf of all the partners in the firm of Chartered Accountants in practice or all the partners of the firm can collectively sign the tax audit reports.

In the instant case, there are 6 partners in M/s XYZ & Co., a Chartered Accountants firm, accordingly specified ceiling limit for the firm will be (60 tax audit assignments per partner X 6 partners) = 360. Therefore, all the 6 partners of the firm can collectively sign 360 tax audit reports. This maximum limit of 360 tax audit assignments may be distributed between the partners in any manner whatsoever. For instance, 1 partner can individually sign 360 tax audit reports in case remaining 5 partners are not signing any tax audit report.

Assuming Mr. Gaurav has signed 290 tax audit reports consisting of both corporate and non-corporate assessee on behalf of firm and remaining partners are signing audit reports within the specified number of tax audit assignments u/s 44AB i.e. upto 70.

Hence, Mr. Gaurav shall not be deemed to guilty of professional misconduct provided total number of tax audit reports on behalf of firm do not exceeds 360.

- (c) **Accepting Appointment as an Auditor:** As per Chapter 7 of Council General Guidelines 2008, a member of the Institute of Chartered Accountants of India in practice shall be deemed to be guilty of professional misconduct if he accepts appointment as auditor of an entity in case the undisputed audit fee of another chartered accountant for carrying out the statutory audit under Companies Act or various other statutes has not been paid.

As per the proviso, such prohibition shall not apply in case of a sick unit where a sick unit is defined to mean "where the net worth is negative".

In the instant case, though the undisputed fees are unpaid, Mr. Z would still not be guilty of professional misconduct since the M/s NCT Limited. is a sick unit having negative net worth for the year 2013-14.

- (d) **Fundamental Principles as per Code of Ethics:** In order to achieve the objectives of the Accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles as discussed in Code of Ethics of ICAI, to be complied, are given below:

- (i) Integrity
- (ii) Objectivity
- (iii) Professional Competence and Due Care
- (iv) Confidentiality
- (v) Professional Behaviour

Threats involved while Complying with Fundamental Principles:

- (i) **Integrity** - To maintain honesty and integrity in professional relationship would be a threat for the professional accountant.
- (ii) **Objectivity** - A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional judgments for example intimidation threat.
- (iii) **Professional Competence and Due Care** - A professional accountant has a continuing duty to maintain professional knowledge based on current developments, and should act in accordance with applicable technical and professional standards while providing professional services.
- (iv) **Confidentiality** - A professional accountant should respect the confidentiality of information acquired as a result of professional and employment relationships. The

acquired information should not be disclosed to third parties without specific authority unless there is a legal or professional duty to disclose, and should also not be used for personal advantage of any person.

- (v) **Professional Behaviour** - A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Question 7

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

- (a) *Restrictions on investments of funds of a Central Co-operative Society.*
 - (b) *Requirements of a Risk Management process/system in a bank.*
 - (c) *“Trade credit insurance policy” and basic requirements of a trade credit insurance product.*
 - (d) *Write a short note on Records to be maintained for Related party Transactions in terms of Cost Audit.*
 - (e) *Objectives of compilation engagement.*
- (4 x 4 = 16 Marks)

Answer

- (a) **Restrictions on Investment of funds of a Central Co-operative Society** - According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:
- (i) In the Central or State Co-operative Bank.
 - (ii) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
 - (iii) In the shares, securities, bonds or debentures of any other society with limited liability.
 - (iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
 - (v) In any other moneys permitted by the Central or State Government.
- In the principal provision relating to the investments of funds of a co-operative society, the Central as well as State Acts do not mention anything about the investment of reserve fund outside the business specifically.
- (b) **Requirements of a Risk Management Process/ system in a bank:** Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:
- (i) **Oversight and involvement in the control process by those charged with governance:** Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

- (ii) **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
 - (iii) **Control activities:** A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.
 - (iv) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
 - (v) **Reliable information systems:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.
- (c) **"Trade Credit Insurance Policy" and basic requirements of a trade credit insurance product:**
- "Trade Credit insurance policy" is a conditional insurance contract between two parties (insurer and seller) that cannot be traded and is always directly related to an underlying trade transaction, which is either the delivery of goods or of services. The correct fulfilment of this trade transaction and satisfaction of the contract terms is essential for credit cover to exist.
- Basic Requirements of a Trade Credit Insurance Product:** An insurer shall offer trade credit insurance product only if all requirements mentioned below are met -
- (i) Policyholder's loss is non-receipt of trade receivable arising out of a trade of goods or services.
 - (ii) Policyholder is a supplier of goods or services in consideration for a fair market value.
 - (iii) Policyholder's trade receivable does not arise out of factoring or reverse factoring arrangement or any other similar arrangement.
 - (iv) Policyholder has a customer (*i.e.* Buyer) who is liable to pay a trade receivable to the policyholder in return for the goods and services received by him from the policyholder, in accordance with a policy document filed with the insurer.
 - (v) Policyholder undertakes to pay premium for the entire Policy Period.
 - (vi) Any other requirement that may be specified by the Authority from time to time.
- (d) **Records to be maintained for Related Party Transactions in terms of Cost Audit:** In respect of related party transactions or supplies made or services rendered by a company

to a company termed 'related party relationship' and vice-a-versa, records shall be maintained showing contracts entered into, agreements or understanding reached in respect of-

- (i) purchase and sale of raw materials, finished goods, rendering of services, process materials and rejected goods including scraps and other related materials;
 - (ii) utilisation of plant facilities and technical know-how;
 - (iii) supply of utilities and any other services;
 - (iv) administrative, technical, managerial or any other consultancy services;
 - (v) purchase and sale of capital goods including plant and machinery; and
 - (vi) any other payment related to the production of goods or rendering of services under reference.
- (e) **Objective of a Compilation Engagement:** As per SRS 4410 "Engagements to Compile Financial Information", the objective of a compilation engagement is for an accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with professional competence and due care.

A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarisation of other financial information, for example, preparation of quarterly financial results, restatement of financial statements in accordance with a financial reporting framework other than in accordance with which the financial statements to be restated are already prepared and presented.