PAPER – 3 : ADVANCED AUDITING AND PROFESSIONAL ETHICS

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

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

Question 1

(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 Accounting Standards (Ind-AS), the company has to prepare its financial statements for the year ended 31st March, 2017 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?

(b) You have been appointed statutory auditor of a company for the financial year ended 31st March, 2017 in place of the retiring auditor. During the course of audit, you observe that a fraud had been committed by a general manager who retired in March 2017. While going into further details, it was found that the fraud was going on since last 2-3 years and the total amount misappropriated was likely to exceed ₹ 100 lakhs. As statutory auditor, what would be your reporting responsibilities to the government?

(c) D Ltd., a Delhi based company having turnover of ₹ 25 crores, has a branch at USA having a turnover of ₹10 lakhs (as converted from US dollars). The area where the branch office is located in USA was severely affected by storms and the office alongwith all accounting records was completely destroyed. Due to the unavailability of records, the financial statements of D Ltd. for the financial year 2016-17 did not include the figures pertaining to the said branch. As the statutory auditor of D Ltd., how will you report on the same?

(d) G Ltd. has paid up capital of ₹ 20 crores divided into equity shares of ₹ 10 each on 31st March, 2016. During the year 2016-17 the company issued bonus shares in the ratio of 1:1. The net profit of the company for the financial years 2015-16 and 2016-17 was ₹ 10 crores and ₹ 15 crores respectively. The Earnings per share (EPS) as disclosed by the company for the 2 year was ₹ 5 and ₹ 3.75 respectively. As the statutory auditor of G Ltd. comment on the above. ***(5 x 4 = 20 Marks)***

Answer

(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. 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) Obligation of the Statutory Auditor to report frauds to the Central Government during the audit carried out under the Companies Act, 2013: As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of rupees 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

In the instant case, a fraud had been committed by a general manager and the amount involved for such misappropriation is exceeding 100 Lakh rupees i.e. 1 crore. Therefore, reporting of fraud should be done to Central Government in accordance with section 143(12) of the Act.

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.

(c) Branch Audit: As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

In the given situation, D Ltd. is a Delhi based company, having total turnover of ₹25 crores. The company is having a branch office in USA (having a turnover of rupees 10 lakhs i.e. as converted from US dollars) in an area which is recently affected by storm and the office along with all accounting records was completely destroyed. Due to unavailability of records, the financial statements of D Ltd. for the financial year 2016-17 did not include the figures pertaining to the said branch.

Under such a circumstance beyond the control of the entity when the entity's accounting records have been destroyed the auditor's opinion has to be modified. The auditor has also to mention in his report the effect on the financial statements due to non-inclusion of financial data pertaining to the branch.

(d) Disclosure of Earnings Per Share: AS 20 on Earning Per Share (EPS) prescribes principles for the determination and presentation of EPS. As per AS 20, the earnings per share have to be disclosed as basic and diluted earnings per share on the face of the Statement of Profit and Loss for each class of equity shares that has a different right to share in the net profit for the period.

In the instant case, G Ltd., both the basic as well as the diluted earnings per share would be the same since there are no dilutive instruments that have been issued by the company. As per AS 20, in the case of a bonus issue, equity shares are issued to existing shareholders for no additional consideration and thus would lead to increase in number of equity shares without any adjustment to outstanding capital amount.

Therefore, the number of equity shares outstanding is increased without an increase in resources. The standard further requires that the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Hence the EPS calculated as on 31-03-2016 would be Adjusted EPS and the same would be disclosed. In view of the above, the EPS will be calculated as under:

As on 31.03.2016 $\dfrac{\text{Profits}}{\text{Adjusted No. of Shares}}$ = Adjusted EPS

$\dfrac{10,00,00,000}{4,00,00,000}$ = ₹ 2.5

As on 31.03.2017 $\dfrac{\text{Profits}}{\text{No. of shares}}$ = EPS

$\dfrac{15,00,00,000}{4,00,00,000}$ = ₹ 3.75

Since the above figures of EPS have not been disclosed, G Ltd. has not complied with the provisions of AS 20. Therefore, the auditor will have to qualify his report in terms of section 143(3)(e) of the Companies Act, 2013.

Question 2

(a) *CA. X is a chartered accountant in practice. He has an articled trainee H. X has informed H that since his practice and receipt of fees is seasonal, the stipend would not be paid in the months of April to December, but would be paid from January to March and the shortfall for the earlier 9 months will be made good in these 3 months alongwith interest @ 5% p.a. Comment with reference to the Chartered Accountant Act, 1949.*

(b) *CA. D, a chartered accountant in practice availed of a loan against his personal investments from a bank. He issued 2 cheques towards repayment of the said loan as per the instalments due. However, both the cheques were returned back by the bank with the remarks "Insufficient funds". Comment with reference to the Chartered Accountants Act, 1949.*

(c) *A CA firm M/s GST & Associates, has sent a letter to the Goods and Service Tax Council stating that the firm has 2 partner who specialise in the law of Goods and Service Tax and asked the said Council to include their name in the panel, whenever formed, for providing advisory and audit services for Goods and Service Tax. Comment with reference to the Chartered Accountants Act, 1949.*

(d) *A Co-operative society having receipts over ₹ 2 crores has appointed Mr. D as the statutory auditor - Mr. D is eligible to do the same under the state Co-operative Societies Act. Mr. D is not a chartered accountant. Mr. D is also appointed to conduct the tax audit of the society under section 44 AB of the Income Tax Act, 1961. Comment.* ***(4 x 4 = 16 Marks)***

Answer

(a) Contravening Provisions of the Act: A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct under Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council.

In the given case, CA. X has failed to make the payments of stipend to articled assistant every month in accordance with Regulation 48. The fact that the articled assistant will be compensated with extra sum in the form of interest on late payment is not relevant and the plea that cycle of professional receipts from clients is seasonal is not acceptable.

Therefore, CA. X is guilty of professional misconduct under Clause (1) of Part II of the Second Schedule to the Chartered Accountants Act, 1949 as he has contravened Regulation 48 by not making the payment every month.

(b) Bringing Disrepute to the Profession: A Chartered Accountant is expected to maintain the highest standard of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work would expose him to disciplinary action.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any professional or "Other Misconduct".

As per Clause (2) of Part IV of the First Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he 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.

The question whether a particular act or omission constitutes "other misconduct" should be based on facts and circumstances of each case.

Under Negotiable Instruments Act 1881, where any cheque drawn by a person for the discharge of any liability is returned by the bank unpaid, either for insufficiency of funds or the cheque amount exceeds the arrangements made by the drawer of the cheque, the drawer of such cheque shall be deemed to have committed an offence.

In the given case the cheque was dishonoured with the remark "Insufficient Funds". Therefore, CA D is liable for misconduct under Clause 2 of Part IV of the First Schedule of the Chartered Accountants Act, 1949.

(c) Making Roving Inquiries: Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of misconduct if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means. Such a restraint has been put so that the members maintain their independence of judgement and may be able to command respect from their prospective clients.

In case of making an application for the empanelment for the allotment of audit and other professional work, the Council has opined that, "where the existence of such a panel is within the knowledge of the member, he is free to write to the concerned organization with a request to place his name on the panel. However, it would not be proper for the member to make roving inquiries by applying to any such organization for having his name included in any such panel."

Accordingly, CA. Firm M/s GST & Associates and its partners are guilty of misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 as it has solicited professional work from the Goods and Service Tax Council, by inquiring about the maintenance of the panel and advertising about 2 partners in the firm having specialized knowledge of GST Law.

(d) Furnishing Audit Report of a Co-operative Society: As per Section 44AB read with Explanation to Section 288(2) of the Income Tax Act, 1961, "accountant" means a chartered accountant within the meaning of the Chartered Accountants Act, 1949, and includes, in relation to any State, any person who by virtue of the provisions of section 141 of the Companies Act, 2013, is entitled to be appointed to act as an auditor of companies registered in that State.

Accordingly, the person who is not a Chartered Accountant as mentioned in the question, though is eligible to act as auditor of Cooperative Society under the Cooperative Society Act, 1912, but is not eligible to carry out tax audit under Section 44AB of the Income Tax Act, 1961.

Hence, such audit report cannot be furnished as tax audit report under Section 44AB of the Income-tax Act, 1961.

Question 3

(a) Explain the circumstances which require a modification to the Auditor's Opinion.

(b) Under what heads can the frauds committed by Non-Banking Financial Companies (NBFCs) be classified?

(c) The auditor of XY & Co. Ltd. has intimated the management that certain misstatements identified during the course of audit need to be corrected. As an auditor, discuss the impact of such misstatements in case the management does not carry out the said corrections.

(6 + 5 + 5 = 16 Marks)

Answer

(a) Modifications in Audit Report: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", the auditor may modify the opinion in the auditor's report in the following circumstances:

(i) If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(ii) If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.

Types of Modification to the Auditor's Opinion: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned:

(i) **Qualified Opinion:** The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) **Adverse Opinion:** The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(iii) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

(b) Classification of Frauds by NBFC: In order to have uniformity in reporting, frauds have been **classified** as under -

(i) Misappropriation and criminal breach of trust.

(ii) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(iii) Unauthorised credit facilities extended for reward or for illegal gratification.

(iv) Negligence and cash shortages.

(v) Irregularities in foreign exchange transactions.

(vi) Cheating and forgery.

(vii) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (iv) and (v) above are to be reported as fraud if the **intention to cheat/ defraud** is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

(i) cases of cash shortages more than ₹ 10,000/- and

(ii) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

NBFCs having overseas branches/offices should report all frauds perpetrated at such branches/offices also to the Reserve Bank as per the prescribed format and procedures.

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

(i) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

(ii) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

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

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

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

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

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

Question 4

(a) Mr. Q is the proprietor of a very profitable business dealing in speciality chemicals. Due to his old age, Mr. Q wants to sell his business and has approached XYZ Pvt. Ltd., a competitor, for the same. As an advisor to XYZ Pvt. Ltd., you are appointed to do a 'Due Diligence' of the business. Enumerate the points which you would look into as part of the Due diligence exercise.

(b) A Ltd. has paid Minimum Alternate Tax (MAT) under section 115JB of the Income Tax Act, 1961 for the year ended 31st March, 2017. The company wants to disclose the same as an 'asset' in the balance sheet since the company contends that it is eligible to claim credit for the same in future years. As the auditor of the company, comment on the above.

(c) Discuss the points and indications to be noted while examining and evaluating the 'Going Concern' assumption for an entity. ***(6 + 4 + 6 = 16 Marks)***

Answer

(a) A due diligence audit on behalf of XYZ Pvt. Ltd. with a view to acquiring the business shall involve following steps:

(1) Brief history of the target and background of its promoters - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the target may reveal its turning points, survival strategies adopted by the target from time to time, the market share enjoyed by the target and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations

(2) Accounting policies - The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale. The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

(3) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target have been prepared in accordance with the Statute governing the target, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target in great detail. It is important to make an evaluation of the profit reported by the target. The reason being the price of the target would be largely based upon its operating results. The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period.

(4) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. Generally taxes are levied both by the Central Government as well as by the State Government. Further taxes may be direct or indirect. Most of the tax laws require the enterprise to register itself with the government and it is important to check if all necessary registrations have been made. The accountant has to also look at the tax effects of the merger or acquisition.

(5) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check if a) Is the company able to honour its commitments to its trade payables, to the banks, to government and other stakeholders b) How well is the company able to turn its trade receivables and inventories c) How well does it deploy its funds d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(6) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask to give projections on optimistic, pessimistic and most likely bases.

Ordinarily, it would be desirable that the accountant evaluates the appropriateness of assumption used in the preparation and presentation of financial projections. If, the accountant is of the opinion that as assumption used by the target is unrealistic, the accountant should consider its impact on the overall valuation of the company. He should offer his comments on all the assumption, highlighting those which, in his opinion are not inappropriate. In case he feels the projections provided by the target are not achievable or aggressive he has to mention this in his report. He should thoroughly check the arithmetic of the calculations made for financial projections.

(7) Management and Employees - In the Indian context, the status of work force, staff and employees and their demands is a complex problem. In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation.

It is important to see if all employee benefits like Provident Fund (P.F.), Employees State Insurance (E.S.I), Gratuity, leave and Superannuation have been properly paid/ provided for/funded. In case of un-funded Gratuity, an actuarial valuation of the liability has to be obtained from a reputed actuary. The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(8) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

In addition to the above steps, the following further points have to be seen:

(i) Reason for sale of business and the effect on turnover and profits due to the exist of the present proprietor.

(ii) The length of the lease under which business has been operating.

(iii) The unexpired period of patents if any held by the vendors.

(iv) The age of managerial staff and prospects of their continuing in service in the new environment; the effect of trained managerial staff learning the organisation in production/sales/administrative and the financial liability to pay terminal benefits/ compensation, etc.

(v) If bulk sales are to a few limited customers, the profitability should be discounted greatly, because any substantial withdrawal of customers might cause business crashes.

(vi) A company with a sound financial structure can better withstand the stresses and strains of business. A low debt-equity ratio would indicate an ability to grow through debt financing without raising equity.

(vii) The cash generated from operations; the need for redeployment of resources and funds needed for repayment of loans become major factors in determining growth potential.

(viii) The valuation of goodwill if any should be on reasonable basis having regards to all factors mentioned above.

(b) Minimum Alternate Tax – Eligible to Claim the Credit: As per the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income-tax Act, 1961 is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Framework provide the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

In addition to the above, the auditor shall take a confirmation letter from the assessee for the said facts.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset.

(c) Evaluating Going Concern Assumption*:* SA 570 "Going Concern", requires that while planning and performing audit procedure and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications-

Financial Indications.

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications.

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other Indications.

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Question 5

(a) As an auditor of DEF Ltd., you notice certain differences in the figures between the books of account and the 'Offer document' for the proposed issue of securities. The company explains that the same is due to certain adjustments as per the SEBI (Disclosure and Investor Protection) Guidelines. What are such disclosures and adjustments to be incorporated in the financial statements included in the 'Offer document'?

(b) As an auditor appointed under section 44AB of the Income Tax Act, 1961, how would you verify and report on the following:

(i) The assesse has borrowed ₹ 50 lakhs from various persons-partly in cash and partly by account payee cheque.

(ii) The assesse has paid rent of ₹ 5 lakhs for premises to his brother.

(c) JKH Pvt Ltd. who is into the business of imparting coaching to CA students did not appoint any internal auditor for the year ended 31st March, 2017. As on 31st March, 2016, the company had paid up capital of ₹ 50 lakhs and reserves of ₹ 10 crores. Its turnover for the 3 years preceding the year ended 31st March, 2017 was ₹ 75 crores, ₹ 145 crores and ₹ 260 crores respectively. As an auditor of the company for the year ended 31st March, 2017, how would you deal with the above? ***(6 + 6 + 4 = 16 Marks)***

Answer

(a) Disclosures and Adjustments to be incorporated in the Financial Statements included in the Offer Document:

(i) All significant accounting policies and standards followed in the preparation of financial statements shall be disclosed.

Statement of assets and liabilities and profit and loss or any other financial shall be incorporated after making the following adjustments wherever quantification is possible.

(ii) Adjustments for all incorrect accounting practices or failure to make provisions or other adjustments, which resulted in audit qualification.

(iii) As per ICDR Regulations, material amounts relating to adjustments for previous years should be adjusted in arriving at the profits for the years to which they relate irrespective of the year in which event triggering the profit or loss has occurred.

(iv) Where there has been a change in accounting policy, the profits or losses of the earlier years (required to be shown in the prospectus) and of the year in which the change in accounting policy has taken place should be recomputed to reflect the profits or losses of those years that would have been if a uniform accounting policy was followed in each of these years.

(v) Statement of profit or loss should disclose the profit or loss arrived at before and after considering the profit or loss from extraordinary items.

(vi) The statement of assets and liabilities should be prepared after deducting the balance outstanding on revaluation reserve account both from fixed assets and reserves and the net-worth arrived at after such deductions.

(b) (i) Borrowal of ₹ 50 Lakhs: As per Clause 31 of Form 3CD the particulars of each loan or deposit taken or accepted during the previous year have to be stated in the Tax Audit Report.

Further, Clause 31(a) requires reporting in case if the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

In addition, as per Clause 31(c) the tax auditor has to state whether the taking or accepting loan or deposit, or repayment of the same were made by account payee cheque drawn on a bank or account payee bank draft based on the examination of books of account and other relevant documents.

Furthermore, the tax auditor has the responsibility to verify the compliance with the provisions of section 269SS and 269T of the Income Tax Act.

Therefore, in the present case, where the assessee has borrowed ₹ 50 Lakhs by way of cash and partly by way of Account payee cheque, needs to be verified and to be **reported in compliance** with Clause 31 of Form 3CD.

(ii) Payment of Rent: A tax auditor has to report under Clause 23 of Form 3CD which deals with the particulars of payments made to persons specified under section 40A(2)(b) of the Income Tax Act, 1961. Where the assessee is an individual, the specified persons include any relative of the assessee (i.e. Husband, Wife, Brother, Sister or any other Lineal Ascendant or Descendant).

In the present case, an assessee has paid rent to his brother ₹ 5,00,000 which may be disallowed if, in the opinion of the Assessing Officer, such expenditure is excessive or unreasonable having regard to:

(1) the fair market value of the goods, services or facilities for which the payment is made; or

(2) for the legitimate needs of business or profession of the assessee; or

(3) the benefit derived by or accruing to the assessee from such expenditure.

Hence, this fact needs to be reported in the Tax Audit Report accordingly besides compliance with TDS provisions, disallowance for cash payments and details under Clause 21(d) & 34(a) of Form 3CD.

(c) Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with Rule 13 of Companies (Audit and Auditors) Rules, 2014 every private company shall be required to appoint an internal auditor or a firm of internal auditors, having -

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year:

In the instant case, JKH Pvt. Ltd. is having turnover of ₹ 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit.

Question 6

(a) Enumerate the specific risks that Information Technology (IT) systems can pose to an entity's internal control.

(b) What are the types of Operational Audits?

(c) What is 'Other Comprehensive Income' as per Ind-AS? What are its components?

(5 + 6 + 5 = 16 Marks)

Answer

(a) Specific Risk to an Entity's internal Control: As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are–

(i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.

(ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.

(iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorised changes to data in Master files.

(v) Unauthorised changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs.

(vii) Inappropriate manual intervention.

(viii) Potential loss of data or inability to access data as required.

(b) Type of Operational Audits: There are three broad categories of operational auditors: functional, organizational, and special assignments. In case, part of the audit is likely to concern evaluating internal controls for efficiency and effectiveness.

(i) Functional Audits - Functions are a means of categorizing the activities of a business, such as the billing function or production function. There are many different ways to categorize and subdivide functions. For example, there is an accounting function, but there are also cash disbursements, cash receipt, and payroll disbursement functions. There is a payroll function, but there are also hiring, timekeeping, and payroll disbursement functions. As the name implies, a functional audit deals with one or more functions in an organization. It could concern, for example, the payroll function for a division or for the company as a whole.

A functional audit has the advantage of permitting specialization by auditors. Certain auditors within an internal audit staff can develop considerable expertise in an area, such as production engineering. They can more efficiently spend all their time auditing in that area. A disadvantage of functional auditing is the failure to evaluate interrelated functions. The production engineering function interacts with manufacturing and other functions in an organization.

(ii) Organizational Audits - An operational audit of an organization deals with an entire organizational units, such as a department, branch, or subsidiary. An organizational audit emphasizes how efficiently and effectively functions interact. The plan of organization and the methods to coordinate activities are especially important in this type of audit.

(iii) Special Assignments - In operational auditing, special assignments arise at the request of management. There are a wide variety of such audits. Examples include determining the cause of an ineffective IT system, investigating the possibility of fraud in a division, and making recommendations for reducing the cost of a manufactured product.

(c) Other Comprehensive Income as per Ind-AS and its Components: Other comprehensive income comprises items of income and expenses (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Ind AS.

The Standard requires an entity to disclose reclassification adjustments and income tax relating to each component of other comprehensive income. Reclassification adjustments are the amounts reclassified to profit or loss in the current period that were previously recognised in other comprehensive income.

Components of Other Comprehensive Income:

(i) Changes in revaluation surplus;

(ii) Re-measurements of the defined benefit plans;

(iii) Equity Instruments through Other Comprehensive Income;

(iv) Fair value changes relating to own credit risk of financial liabilities designated at fair value through profit or loss;

(v) Share of Other Comprehensive Income in Associates and Joint Ventures, to the extent not to be classified into profit or loss; and

(vi) Exchange differences in translating the financial statements of a foreign operation;

(vii) Debt instruments through Other Comprehensive Income;

(viii) The effective portion of gains and loss on hedging instruments in a cash flow hedge;

(ix) Share of other comprehensive income in Associates and Joint Ventures, to the extent to be classified into profit or loss; and

(x) Others (specify nature)

Question 7

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

(a) Requirement for Audit Committee as per Companies Act, 2013

(b) Areas not to be examined in Peer Review

(c) Format of audit report for a Stock broker

(d) Financial vs. Operational Audit

(e) Contents of audit report given by Comptroller & Auditor-General of India.

(4 x 4 = 16 Marks)

Answer

(a) Requirement for Audit Committee as per Companies Act, 2013: Requirements relating to Audit Committee is discussed in Section 177 of the Companies Act, 2013.

As per the section 177 of the Companies Act, 2013, every listed company and the following classes of companies shall constitute an Audit Committee -

(i) all public companies with a paid up capital of ten crore rupees or more;

(ii) all public companies having turnover of one hundred crore rupees or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation- The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

(b) Areas not to be Examined in Peer Review are:

(i) Management Consultancy Engagements;

(ii) Representation before various Authorities;

(iii) Engagements to prepare tax returns or advising clients in taxation matters;

(iv) Engagements for the compilation of financial statements;

(v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;

(vi) Testifying as an expert witness;

(vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and

(viii) Engagement for Due diligence.

(c) Format of Audit Report for a Stock Broker: As per the notification issued by the Government, an auditor should submit his report in the following form:

"We have audited the attached balance sheet of M/s. ABC as at _________ and the profit and loss account for the year ended on that date annexed thereto and report that:

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

In our opinion, proper books of account and records as specified in Rule 15 of the Securities Contracts (Regulation) Rules, 1957 have been kept so far as appears from our examination of such books.

The stock broker has complied with the requirements of the stock exchange so far as they relate to maintenance of accounts and was regular in submitting the required accounting information to the stock exchange.

The balance sheet and the profit and loss account referred to in this report are in agreement with the books of account.

In our opinion and to the best of our information and according to the explanations given to us, the said balance sheet and the profit and loss account read together with the notes thereon give a true and fair view insofar as it relates to the balance sheet, of the state of affairs of M/s. ABC, and insofar as it relates to profit and loss account, of the profit of M/s. ABC for the year ended on that date."

(d) Financial Audit vs. Operational Audit: The major differences between financial and operational auditing can be described as follows-

(i) Purpose - The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.

(ii) Area - Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.

(iii) Reporting - The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However, the operational audit report is primarily for the management.

(iv) End Task - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also.

(e) Contents of Audit Report given by Comptroller and Auditor General: For facility of consideration, the reports of the Comptroller and Auditor General on the public sector undertakings of the Central Government are presented to the Parliament in several parts consisting of the following:

(i) Introduction containing a general review of the working results of Government companies, deemed Government companies and corporations.

(ii) Results of comprehensive appraisals of selected undertakings conducted by the Audit Board.

(iii) Resume of the company auditors' reports submitted by them under the directions issued by the Comptroller and Auditor General and that of comments on the accounts of the Government companies.

(iv) Significant results of audit of the undertakings not taken up for appraisal by the Audit Board.