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## SUGGESTED ANSWERS

### FTR

#### PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

**Answer 1 (a) : As per SRE 2400, “Engagement to Review Historical Financial Statements”, prior to accepting a review engagement, the practitioner shall:**

- (1) Determine whether the financial reporting framework applied in the preparation of the financial statements is acceptable including, in the case of special purpose financial statements, obtaining an understanding of the purpose for which the financial statements are prepared and of the intended users; and
- (2) Obtain the agreement of management that it acknowledges and understands its responsibilities:
  - (i) For preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;
  - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
  - (iii) To provide the practitioner with:
    - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
    - b. Additional information that the practitioner may request from management for the purpose of the review; and
    - c. Unrestricted access to persons within the entity from whom the practitioner determines it necessary to obtain evidence



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If the practitioner is not satisfied as to any of the matters set out above as preconditions for accepting a review engagement, the practitioner shall discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the practitioner as to those matters, the practitioner shall not accept the proposed engagement unless required by law or regulation to do so. However, an engagement conducted under such circumstances does not comply with this SRE. Accordingly, the practitioner shall not include any reference within the practitioner's report to the review having been conducted in accordance with this SRE.

If it is discovered after the engagement has been accepted that the practitioner is not satisfied as to any of the above preconditions, the practitioner shall discuss the matter with management or those charged with governance, and shall determine:

- (a) Whether the matter can be resolved;
- (b) Whether it is appropriate to continue with the engagement; and
- (c) Whether and, if so, how to communicate the matter in the practitioner's report.

***Answer 1(b): Engagements to Report on the Compilation of Pro Forma Financial Information:***

As per SAE 3420," Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus", before agreeing to accept an engagement to report on whether pro forma financial information included in a prospectus has been compiled, in all material respects, on the basis of the applicable criteria, the practitioner shall-

- (a) Determine that the practitioner has the capabilities and competence to perform the engagement;
- (b) On the basis of a preliminary knowledge of the engagement circumstances and discussion with the responsible party, determine that the applicable criteria are suitable and that it is unlikely that the pro forma financial information will be misleading for the purpose for which it is intended;
- (c) Evaluate the wording of the opinion prescribed by the relevant law or regulation, if any, to determine that the practitioner will likely be able to express the opinion so prescribed based on performing the procedures specified in this SAE;
- (d) Where the sources from which the unadjusted financial information and any acquiree or divestee financial information have been extracted have been audited or reviewed and a modified audit opinion or review conclusion has been expressed, or the report contains an Emphasis of Matter paragraph, consider whether or not the relevant law or regulation permits the use of, or reference in the practitioner's report to, the modified audit opinion or review conclusion or the report containing the Emphasis of Matter paragraph with respect to such sources;
- (e) If the entity's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the entity and its accounting and financial reporting practices to perform the engagement;

- (f) If the event or transaction includes an acquisition and the acquiree's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the acquiree and its accounting and financial reporting practices to perform the engagement; and
- (g) Obtain the agreement of the responsible party that it acknowledges and understands its responsibility for:
- Adequately disclosing and describing the applicable criteria to the intended users if these are not publicly available;
  - Compiling the pro forma financial information on the basis of the applicable criteria; and
  - Providing the practitioner with:
    - Access to all information (including, when needed for purposes of the engagement, information of the acquiree(s) in a business combination), such as records, documentation and other material, relevant to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria;
    - Additional information that the practitioner may request from the responsible party for the purpose of the engagement;
    - Access to those within the entity and the entity's advisors from whom the practitioner determines it necessary to obtain evidence relating to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; and
    - When needed for purposes of the engagement, access to appropriate individuals within the acquiree(s) in a business combination.

**Answer 1 (c) :**

The purpose of this SRS 4410 Compilation engagement is to establish standards on the professional responsibilities of the Practitioner, when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report issued in connection with such a compilation so that the association of the name of the Practitioner with the financial statements is not misconstrued by a user of those statements or information as having been audited by him. 2) The objective of a compilation engagement is for an Practitioner to use accounting expertise, as opposed to auditing expertise, to collect, classify and summaries financial information.

The Practitioner should obtain a general knowledge of the business and operations of the entity and should be familiar with the accounting principles and practices of the industry in which the entity operates and with the form and content of the financial statements / other financial information that is appropriate in the circumstances.



## Practitioner

1. Make any inquiries of management to assess the reliability and completeness of the information provided;
2. Assess internal controls;
3. Verify any matters; or
4. Verify any explanations.
5. The Practitioner may also request the management to provide additional information.

This may be asked in the form of management representation letter. If the management refuses to provide additional information, the Practitioner should withdraw from the engagement, informing the entity of the reasons for such withdrawal. 6. If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the Practitioner should include the same in notes to the accounts and the compilation report to the management.

### Answer 1 (d) :

As per SA 810, "Engagement to Report on Summary Financial Statements", the auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary financial statements:

- (i) Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.
- (ii) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
  - (1) From whom or where the audited financial statements are available; or
  - (2) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
- (iii) Evaluate whether the summary financial statements adequately disclose the applied criteria.
- (iv) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be re-calculated from the related information in the audited financial statements.
- (v) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.
- (vi) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.



(vii) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.

*Answer 2 (a) :*

CAATs may be used in performing various auditing procedures, including:

1. Tests of details of transactions and balances for example the use of audit software to test all (or a sample) of the transactions in a computer file.
2. Analytical review procedures - for example, the use of audit software to identify unusual fluctuations of items.
3. Compliance test of general EDP controls - for example, the use of test data to test access procedures to the program libraries, by using code comparison software to check that the version of the program in use is the version approved by management;
4. Compliance test of EDP application controls - for example, the use of test data to test the functioning of a program procedure.
5. Re-performing calculations performed by the entity's accounting systems
6. Sampling programs to extract data for audit testing
7. Tests of application controls, for example, testing the functioning of a programmed control.

However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. Sometimes, in some accounting systems that use of computer for processing significant applications, it may difficult or impossible for an auditor to obtain certain data for inspection, inquiry or confirmation without computer assistance. CAAT in Fraud Detection: In a CIS Environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error. Use of the CAAT/ audit software systems will help the auditor to identify errors and frauds in the accounting and internal control system. Conclusion: Frauds are intentional. Auditing through the computer with adequate knowledge of computer systems may highlight some frauds, but there is no empirical evidence to prove the assertion that the use of audit software systems has unearthed well concealed frauds.

**Answer 2 (b) :**

SA 560 on “Subsequent Events” establishes standards on the auditor’s responsibility regarding subsequent events.

SA 560 on “Subsequent Events” states that the term “subsequent events” refers to events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report.

**Subsequent Events:** This case requires attention to SA 560 “Subsequent Events”, AS 4 “Contingencies and Events occurring after the Balance Sheet Date” and AS 29 “Provisions, Contingent liabilities and Contingent Assets”. As per AS 4 “Contingencies and Events occurring after the Balance Sheet Date”, adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 “Provisions, Contingent liabilities and Contingent Assets”, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the will occur.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor’s report, or as near as practicable thereto. xi) The auditor shall take into account the auditor’s risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings, of the entity’s owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity’s latest subsequent interim financial statements, if any.

In the instant case, the amount of Rs. 1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements. The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31-3-2015 to the date of Auditors Report ie. 15-05-2015.

It will be observed that as a result of long pending negotiations a sum of Rs. 1.50 crores representing arrears of salaries of the year 2015-16 and 2016-17 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29. As per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed. So the auditor should request the management to adjust the sum of Rs. 1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

**Answer 2 (c) :**

1. As per SA 240, "The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.
2. In addition an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.
3. As per SA 580, "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist
4. If the Management fails to give Written Representation under SA 580 then the auditor shall:
  - (i) Discuss the matter with management
  - (ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and
  - (iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor should disclaim an opinion on the financial statements if management does not provide written representations. In addition, as per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Audit committee or board within 2 days of his knowledge of fraud seeking for their reply with 45 days from the date of report, & if the amount involved is 1 crore or above then report to Central Government within 15 days if board had replied on the fraud or within 60 days of his knowledge of fraud and following the prescribed procedure. a. The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved has to be indicated. b. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit.



Auditor Shall Determine Applicable professional & legal responsibilities which requires reporting to Person or persons appointed the auditor.

If auditor withdraws from the engagement Whether withdrawal is legally permitted

The reasons for withdrawal to be discussed with management & TCWG , Regulatory authorities in some cases. The auditor should consider whether it is appropriate to withdraw from engagement and whether it is legally permitted. In the instant case, in the course of audit of K Ltd., its auditor Mr. N observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report, which was not provided by the management despite of many reminders. Mr. N also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent. Hence, the fact is required to be reported as per Paragraph 3(x) of the CARO, 2016 and the auditor should also disclaim an opinion on the financial statements.

Answer 3 (a)(i) :

(i) Reporting to Shareholders vs. Reporting to those Charged with Governance:

<b>REPORT</b>	
<b>Reporting to Shareholders</b>	<b>Reporting to those Charged with Governance</b>
<ul style="list-style-type: none"> <li>• Section 143 of the Companies Act, 2013 deals with the provisions relating to reporting to Shareholders. Thus, it is a Statutory Audit Report which is addressed to the members.</li> </ul>	<ul style="list-style-type: none"> <li>• Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.</li> </ul>
<ul style="list-style-type: none"> <li>• Statutory Audit Report is on true and fair view and as per prescribed Format</li> </ul>	<ul style="list-style-type: none"> <li>• It is a reporting on matters those charged with governance like scope of audit, audit procedures, audit modifications, etc.</li> </ul>
<ul style="list-style-type: none"> <li>• Statutory Audit Reports are in public domain.</li> </ul>	<ul style="list-style-type: none"> <li>• Reporting to those Charged with Governance is an internal document i.e. private report.</li> </ul>





(ii) *Audit Qualification vs. Emphasis of Matter*

<b>REPORT</b>	
<b>Audit Qualification</b>	<b>Emphasis of Matter</b>
<ul style="list-style-type: none"><li>• Standard on Auditing 705 “Modifications to the Opinion in the Independent Auditor’s Report”, deals with the provisions relating to Audit Qualification.</li></ul>	<ul style="list-style-type: none"><li>• Standard on Auditing 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report” deals with the provisions relating to Emphasis of Matter.</li></ul>
<ul style="list-style-type: none"><li>• Audit Qualifications are also known as “subject to report” or “except that report”.</li></ul>	<ul style="list-style-type: none"><li>• Emphasis of Matter is a paragraph which is included in auditor’s report to draw users’ attention to important matter(s) which are already disclosed in Financial Statements and are fundamental to users’ for understanding of Financial Statements.</li></ul>
<ul style="list-style-type: none"><li>• Audit Qualifications are given when auditor is having reservations on some of the items out of the financial statements as a whole i.e. Auditor’s Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements relating to if the impact of material misstatements is not pervasive on the financial statements but is present at some levels of the financial statements, qualified report is issued.</li></ul>	<ul style="list-style-type: none"><li>• Emphasis of Matter is a paragraph which is issued when there is a uncertainty relating to future outcome of exceptional litigation, regulatory action, etc.; or there is early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.</li></ul>

**Answer 3 (b):**

**Non-cash Transactions with Relative of Director:**

- (a) As per Clause (xv) if paragraph 3 of CARO, 2016, the auditor is required to report “whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with”.
- (b) Section 192 of the said Act deals with restriction on non-cash transactions involving directors or persons connected with them. The section prohibits the company from entering into such types of arrangements unless it is an arrangement by which the company acquires or is to acquire assets for consideration other than cash, from such director or person so connected.
- (c) In the instant case, RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of director, which is Wan arrangement by which RPS Ltd. is in process to acquire assets for consideration other than cash. In the above situation, the provisions of section 192 of Companies Act, 2013 have been complied with.



- (d) However, the reporting requirements under this clause are given in two parts. The first part requires the auditor to report on whether the company has entered into any non-cash transactions with the directors or any persons connected with such director/s. The second part of the clause requires the auditor to report whether the provisions of section 192 of the Act have been complied with. Therefore, the second part of the clause becomes reportable only if the answer to the first part is in affirmative.
- (e) In the given situation, RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of director which is affirmative answer to the first part of the Clause (xv) of Paragraph 3 of CARO, 2016, thus, reporting is required for the same. Draft report is given below.
- (f) According to the information and explanations given to us, RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of one of the directors during the year, for the acquisition of assets, which in our opinion is covered under the provisions of Section 192 of the Companies Act, 2013.

**Answer 3 (b) (ii):**

**Paragraph 3(x) of CARO, 2016 states that :**

Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated

This clause requires the auditor to report whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover such frauds. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds by the company or on the company by its Officer and employees that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements.

**Answer 3 (c)**

1. The Board shall lay down a code of conduct for all Board members and senior management of the company who shall affirm the same on annual basis. The code of conduct shall be posted on the website of the company.
2. The annual report of the company shall contain a declaration to such affirmation signed by CEO.
3. The code shall incorporate the duties of Independent directors as in Co.'s act, 2013.
4. An independent director shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement.



5. All Board members and senior management personnel shall affirm compliance with the code on an annual basis.
6. The Code of Conduct shall suitably incorporate the duties of Independent Directors as laid down in the Companies Act, 2013
7. The code of conduct shall be posted on the Website of the company Explanation: "Senior management" shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

**Role of Auditor:** The auditor should ascertain:

- I. Whether the Board of Directors of the company has laid down a Code of Conduct for all Board members and senior personnel of the company and obtain a copy of the same.
- II. He should also verify whether all Board members and senior management personnel have affirmed compliance with the code on an annual basis and whether the code has been posted on company's website.

**Answer 4 (a)**

Applicable Clause: Clause 6 of Part I of First Schedule of CA Act 1949 as amended by CA Amendment Act 2006 as per Website guidelines issued in 212th, 235th, 242nd Meeting and 345th Meeting of council of ICAI.

- (a) Firm name is used as website name. Hence, there is no violation.
- (b) There is no restriction on the colours used. Hence, there is no violation.
- (c) Website should work on "pull" model only. Hence this guideline has been violated.
- (d) Names of Partners can be given. However, disclosure of names of clients and/or fees charged, on the website is permissible only where it is required by a regulator, whether or not constituted under a statute, in India or outside India, provided that such disclosure is only to the extent of requirement of the regulator. Where such disclosure of names of clients and/or fees charged is made on the website, the member/firm shall ensure that it is mentioned on the website (in italics), below such disclosure itself, that "This disclosure is in terms of the requirement of (name of the regulator) having jurisdiction in (name of the country/area where such regulator has jurisdiction) vide (Rule/Directive etc. under which the disclosure is required by the Regulator). But names of Major clients cannot be given. Hence this guideline has been violated. Conclusion: In view of the above, M/s XYZ would have no restriction on the colors used in the website but failed to satisfy the other two guidelines. Since the Firm has not complied with the guidelines, it would be liable for professional misconduct as it would amount to soliciting work by advertisement.



- (i) To obtain an understanding of the entity's selection and application of accounting policies. Financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.
- (ii) Compliance of all SAs relevant to audit, the auditor may judge it necessary to depart from a relevant requirement in a SA by performing alternative audit procedures to achieve the aim of that requirement.
- (iii) Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor.
- (iv) In case of Special purpose financial statements prepared in accordance with the requirements of contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with SA 320 for purposes of planning and performing the audit of the special purpose financial statements.
- (v) Communication with those charged with governance in accordance with SAs is based on the relationship between those charged with governance and the financial statements subject to audit, in particular, whether those charged with governance are responsible for overseeing the preparation of those financial statements.

In the case of special purpose financial statements, those charged with governance may not have such a responsibility.

#### Answer 4 (b)

**Maintenance of Books of Account by a CA in Practice:** Chapter V of the Council General Guidelines, 2008 specifies that a member of the Institute in practice or the firm of Chartered Accountants of which he is a partner, shall maintain and keep in respect of his/its professional practice, proper books of accounts including the following-

- (i) A Cash Book
- (ii) A Ledger

Thus, a Chartered Accountant in practice is required to maintain proper books of accounts. In the instant case, CA. Elegant does not maintain proper books of accounts and writes the fees received from various clients in notes in his mobile. Notes maintained by him in mobile cannot be treated as books of accounts.

Hence, CA. Elegant, being a practicing Chartered Accountant will be held guilty of misconduct for violation of Council General Guidelines, 2008



#### Answer 4(c)

Answer Applicable Clause: clause 5 of Part I of Second Schedule of CA Act 1949 as CA Amendment Act 2006  
Comment: As per the clause mentioned above, A CA in Practice will be held liable for misconduct if he fails to disclose a material fact known to him, which is not disclosed in financials but disclosure of which is necessary to make the financial statements not misleading. In this case, the Chartered Accountant was aware of the contraventions and irregularities committed by the trust as these were referred to in the confidential report given by the Chartered Accountant to the trustees of the company. However, he had issued the annual accounts without any qualification. On similar facts it was held by the Supreme court in Kishorilal Dutta vs. P.K. Mukherjee that it was the duty of the Chartered Accountant to have disclosed the irregularities and contravention to the beneficiaries of the fund in the statement of accounts signed by him. In the present case it has to be held that the Chartered Accountant is guilty of professional misconduct if the amount of irregularities is proved material.

#### Answer 4 (d)

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

- i. Orderly and efficient conduct of its business, including adherence to Company's policies,
- ii. Safeguarding of its assets,
- iii. Prevention and detection of frauds and errors,
- iv. Accuracy and completeness of the accounting records, and
- v. Timely preparation of reliable financial information. Internal Financial Controls Over Financial Reporting (ICFR) shall mean: A Process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles”.

The Central Government amends the Notification G.S.R. 464(E), dated 5th June 2015 Vide Notification G.S.R. 583(E) Dated 13th June, 2017. Amendments are given below:

A Company's internal financial control over financial reporting includes those policies and procedures:

- (a) Pertain to the maintenance of the records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company.
- (b) It provides reasonable assurance that transactions are recorded as necessary to permit preparation of financial statement in accordance with generally accepted accounting principles, and those receipts and expenditures of the company are being made only in accordance with authorizations of management and director of the company.
- (c) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition use or disposition of the company's assets that could have a material effects of the Financial statement.



## Provision of Companies Act for Internal financial reporting

- (a) As per section 134 Company Act 2013, In the case of a listed company, the Directors' Responsibility statement highlights that directors, have laid down IFC to be followed by the company and that such controls are adequate and operating effectively.
- (b) As per section 143 Company act 2013, The auditor's report should also state whether the company has adequate IFC system in place and the operating effectiveness of such controls
- (c) As per section 177 Company act 2013, Audit committee may call for comments of auditors about internal control systems before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.
- (d) As per Schedule IV Company Act 2013, The independent directors should satisfy themselves on the integrity of financial information and ensure that financial controls and systems of risk management are robust and defensible.
- (e) As per Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 – The director's report should contain details in respect of adequacy of internal financial controls with reference to the financial reporting. The guidance note is applicable to all the companies as per section 143(3)(i) of the Companies Act, 2013. The auditors will have to report on ICFR in respect of both stand alone and consolidated financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. The auditor needs to obtain reasonable assurance to state whether an adequate internal financial controls system was maintained and whether such internal financial controls system operated effectively in the company in all material respects with respect to financial reporting only.

**Conclusion :** Hence the contention of the Managing director is not correct.

### **Answer 5(a)**

**Answer :** Main Areas to be covered in the Case of Environment Audit of an Industrial Unit:

(i) **Layout and Design** – The layout to be sketched in the style which will allow adequate provisions for installing pollution control devices, as well as provision for up gradation of pollution control measures and the meeting of the requirements of the regulations framed by the Government.

In the course of the audit, the area which requires attention but not attended to by the industry to be pinpointed as well as the future requirements of the environmental measures required in commensuration with the proposed future course of working plan are to be identified.

(ii) **Management of Resources** – Management resources includes air, water, land, energy, raw materials and human resources besides others. The use of all resources is interlinked and the best uses in a synchronised manner results the best output and minimum waste. The waste of resources to the minimum possible extent is good for the health of the industry as well as the environment.



**(iii) Pollution Control System** – An effective system of pollution control should be in existence. One aspect should be whether all required pollution control measures are in vogue or not next aspect should be whether the same is effective or not, further it is to investigate, whether more measures are required, keeping in view the type of industry and its nature of working with respect to its grade of polluting the environment.

**(iv) Emergent Safety Arrangement** – The chemical, gas, etc., industries which are prone to sudden requirement of safety arrangements, must remain alert all the while. The emergency plans are to be reviewed periodically; sufficient staff along with other required safety amenities should be kept ready. The staff, remained so engaged, must possess the required awareness and alertness to meet the contingency. The degree of awareness, however, can be upgraded with proper training provisions.

**(v) Medical & Healthcare Facilities** – The medical services should be maintained. The health of the workers should be a big consideration for the management.

**(vi) Industrial Hygiene** – Proper system should be in vogue to eliminate industrial unhygienic state.

**(vii) Occupational Health** – The requirement for safeguarding against occupational health hazards should be available for all the workers. As the occupational health hazards varies from industry to industry due to the difference in the nature of working atmosphere and the pollutants present in it, the concerned industry must pay proper weightage to those diseases which are prone to that particular type of industry.

**(viii) Information Assimilation and Reporting System** – The information system should be strengthened to generate and its reporting system should be proper, keeping in view, the authorities, responsibilities and subsequent delegations. A report of compliance of all statutory environmental laws along with other preventive and precautionary measures should be put to Board at regular intervals.

**(ix) EIA Methodology** – The Environmental Impact Assessment (EIA) is usually are pre-requisites to start an industry. This is done considering the known spheres of activities on the existing environmental conditions. But the predictions necessarily deviate from the actual happenings when the industry starts working. To accommodate the deviation in the system is also to be incorporated in the EIA report, if it is noticed that the degradation to the environment caused on the establishment and running of the industry is much higher than what was predicted, the mitigatory measures suggested must also be furthered.

**(x) Compliance to the Regulatory Mechanism** – As the persons who are directly working with the system, may be unaware of the latest developments and requirements for the compliance of stipulations and standards prescribed by the various regulatory authorities, they should be trained and instructed on regular basis, to avoid making the Board/owner vulnerable to prosecution and penalty.



### Answer 5 (b)

The audit procedures, which may be followed with regard to agent's balance, are as follows –

1. Verify whether agent's balances and outstanding balances in outstanding premium account have been listed, analysed and reconciled for the purposes of audit.
2. Verify whether recoveries of large outstanding have been made in post audit period.
3. Verify whether there is any old outstanding debit or credit balances as at the year end which require adjustment. A written explanation may be obtained from the management as to their nature.
4. Verify that agent's balances do not include employees' balances and balances of other insurance companies.
5. Verify that no credit of commission is given to agents for businesses directly procured by it.
6. Vouch adjustments / payments against old outstanding balances in agents account.
7. Ensure that the relevant control account in the General Ledger is reconciled with the subsidiary records.
8. Check age-wise, sector-wise analysis of outstanding premium
9. Check the availability of adequate Bank Guarantee or Premium Deposit for outstanding premium.

### Answer 5 (c)

(i) The following points require special attention in the examination of *Inter Branch transactions*.

- (i) While verifying the closing balance, special attention should be paid to the origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding in appropriate cases.
- (ii) Whether there are any reversal entries indicating the possibility of irregular payments or frauds.
- (iii) Whether the balances include any items in the nature of cash in transit included in this head which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.
- (iv) Whether transactions other than those relating to inter branch transactions have been included in inter branch accounts. Any unusual items put through inter branch accounts as well as old or large entries outstanding in Inter branch accounts should be carefully looked into. The auditor should also seek explanations from the Management in this regard in appropriate cases.

(ii) If any advance, including bills purchased and discounted, becomes Non-Performing Assets as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.





### Answer 5 (d)

Reporting of Payments Exceeding Rs. 35,000 in Cash: Disallowance under section 40A(3) of the Income Tax Act, 1961 is attracted if the assessee incurs any expenses in respect of which payment or aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft, exceeds Rs. 10,000. However, in case of payment made for plying, hiring or leasing of goods carriage, limit is Rs. 35,000 instead of Rs. 10,000. Further, as per section 40A(3A) of the Income Tax Act, 1961, where an allowance has been made in the assessment for any year in respect of any liability incurred by the assessee for any expenditure and subsequently during any previous year the assessee makes payment in respect thereof, otherwise than by an account payee cheque drawn on a bank or account payee bank draft, the payment so made shall be deemed to be the profits and gains of business or profession and accordingly chargeable to income-tax as income of the subsequent year if the payments made to a person in a day, exceeds Rs. 10,000 (For AY 2018-19, Rs. 10,000) (Rs. 35,000 in case of plying, hiring or leasing of goods carriages). However, exemption is provided under Rule 6DD having regard to nature and extent of banking facilities available and other relevant factors. Subsequently, under clause 21(d)(A) and 21(d)(B) of Form 3CD, the Tax Auditor has to scrutinize on the basis of the examination of books of account and other relevant documents/evidence, whether the expenditure covered under section 40A(3) and 40A(3A) respectively read with rule 6DD were made by account payee cheque drawn on a bank or account payee bank draft. If not, the same has to be reported under abovementioned clauses. Therefore, as per the provisions and explanations discussed above, the given cases are dealt as under-

- (i) Payments of 6 invoices of Rs. 5,000 each aggregating Rs. 30,000 made in cash on 4th July, 2017 need not be reported as the aggregate of payments do not exceed Rs. 35,000.
- (ii) Payments of 2 invoices of Rs. 18,000 each made in cash on 5th July, 2017 and 6th July, 2017 respectively aggregating Rs. 36,000 need not be reported as the payment do not exceed Rs. 35,000 in day.
- (iii) Payment of Rs. 40,000 made in cash against an invoice for expenses booked in 2016-17 is likely to be deemed to be the profits and gains of business or profession under section 40A(3A) of the Income Tax Act, 1961 in relation to outstanding expenses. Thus, the details of such amount needs to be furnished under clause 21(d)(B) of Form 3CD.

### Answer 6 (a)

**Answer :** *Main Phases in the Conduct of Risk Based Audit:* Risk Based Audit is an approach to audit that analyses audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high risk areas.

These are achieved through the following:



**\* Understand auditee operations to identify and prioritize risks: Understanding auditee**

operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

**\* Assess auditee management strategies and controls to determine residual audit risk:**

Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.

**\* Manage residual risk to reduce it to acceptable level:**

Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.

**\* Inform auditee of audit results through appropriate report:**

The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.

**Answer 6(b)**

**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.



(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.

**Answer 6 (c)**

To be effective, the internal auditor must be regarded as part of the management and not merely as an assistant thereto. He must have authority to investigate from the financial angles, every phase of the organisational activity under any circumstances. In recent years, there has been a growing tendency in Western countries to make the internal auditor responsible directly to the Board of Directors for the maintenance of adequate accounting procedures and for the preparation of financial statements and reports as regards the functioning of the business. His main responsibility, however, must be to maintain adequate system of internal control by a continuous examination of accounting procedures, receipts and disbursements and to provide adequate safe- guards against misappropriation of assets. In carrying out these functions, he must operate independently of the accounting staff and must not in any way divest himself of any of the responsibilities placed upon him. He should also not involve himself in the performance of executive functions in order that his objective outlook does not get obscured by the creation of vested interest.

It may be further pointed out that internal auditors who are qualified accountants, because of their training and experience, can be of great assistance to the management even in fields other than accounting. They can observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, they critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected. In order that an internal auditor may be able to play such a role in the field of management, he must be closely associated with it and his knowledge must be kept up to date by his being kept informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies. Also, he must enjoy an independent status.



In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

#### Answer 6 (d)

The probability of cash being diverted before being entered in the books is very high and hence

1. On the assumption that cash may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinized. Eg: Inventory, sales summaries, rental registers etc.
2. Before proceedings to investigate a suspected embezzlement, the investigating accountant should ascertain the exact duties of the person concerned who is suspected to have committed a fraud. His relationship to the general routine of the office, and the circumstances in which any known instances of defalcation have come to light. Such as the individual suspected of a fraud, wider would be the field which would have to be covered by the investigation.
3. Carbon copies of receipts marked 'duplicate' should be scrutinised to confirm that they are in fact copies of receipts issued earlier.
4. Compare details of cash deposited each day with cash book by recalling paying-in-slips from bank.
5. The record of small or negligible sources of income such as sales of scrap or sale of waste paper. That of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., and other Government authorities should be examined for finding out if any of these amounts have been misappropriated.
6. Cash sales should be vouched in detail.
7. Recoveries from customers and sundry parties along with deductions on account of cash discounts should be reviewed and checked thoroughly.
8. Showing a larger cash discount than actually allowed.
9. All withdrawals from bank should be checked by reference to corresponding bank entries in the pass book.
10. Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.
11. Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.
12. Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.
13. Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.



14. Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.

15. Under-casting the receipts side of the Cash Book or over-casting the payment side; either short banking of cash collection or apart of the amount withdrawal from the bank. 16. He should also examine the line of responsibility between the various members of the staff.

### **7. (a) Mark-to-market (MTM) Margin**

1. It is a notional Loss which a member or his client would incur, if the net cumulative outstanding were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into.
2. It is arrived at by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position.
3. It is payable with reference to net position at client's level.
4. The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to market margin is payable with reference to net position at client's level.

### **7(b) Rolling settlement**

1. A rolling settlement is one in which a transaction outstanding at the end of the day have to be settled (Payments for purchases, delivery in case of sales) within X business days from the transaction date.
2. If a transaction is entered on Monday for instance, on T+2 rolling settlement, it will be settled on Wednesday when the pay in or payout takes place.
3. In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades can be done only for the day & not for multiple days.
4. SEBI has mandated most of the scrips to be settled exclusively on rolling settlement basis.
5. The transactions in the compulsory rolling settlement (CRS) are settled on T+2 basis.
6. If an investor buys and sells X no. of shares on the same day, then he shall may first have to actually deliver and then receive the securities on the settlement day.
7. Value at Risk (VaR) based margin approach has been adopted for transactions done in Compulsory Rolling Settlement.
8. In the VaR system of margin, historical volatilities of scrips and overall market volatility is considered to arrive at a VaR margin percentage for scrip.
9. Further mark-to-market differences are collected on a daily basis and the broker members are required to maintain capital level, as prescribed by exchange, adequate to support their exposure at all times.

10. If a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session to meet the shortfall credited by non-delivery of shares.
11. In auction session, offers are invited from members to deliver the shares sold by original seller, in case not shares are received in auction, the sale transaction is closed at a close-out price, which is higher of the following a. Highest price recorded in the scrip from the settlement in which the transaction took place upto a day prior to the auction. (OR) b. 20% above the closing price on a day prior to the auction.
12. If the auction price/close out price is less than the sale price, the difference is credited to Investor's Education and Protection Fund. If the sale price is less than the auction price/ close out price, the difference is payable by the seller who failed to deliver the scrips

### 7(c) Focus of a peer review

As per the Statement of Peer Review issued by the Institute of Chartered Accountants of India, Peer Review – means an examination and Review of the systems and procedures to determine whether the same have been put in place by the Practice Unit for ensuring the quality of assurance services as envisaged by the Technical, Professional and Ethical Standards and whether the same were consistently applied in the period under review. The Peer Review process shall apply to all the assurance services provided by a Practice Unit. Following is the scope of Peer Review.

1. The assurance engagement records pertaining to the Peer Review Period shall be subjected to Review.
2. The Review shall focus on:
  - (i) Compliance with Technical Standards
  - (ii) Compliance with Ethical Standards.
  - (iii) Compliance with Professional Standards.
  - (iv) Quality of Reporting.
  - (v) Office systems and procedures with regard to compliance of attestation services systems and procedures.
  - (vi) Training Programs for staff (including Articled and Audit Assistants) concerned with attestation functions, including appropriate infrastructure.
  - (vii) Compliance of guidelines issued by council in relation to Article Assistants or Audit assistants in relation to attendance register, Work Diaries and Other Related records.
  - (viii) Compliance with guidelines issued by the Council to the Members, including Fees to be charged, Number of audits undertaken, register for Assurance Engagements conducted during the year and such other related records.



### **7(d) The purpose of communicating key audit matters**

As per SA 701 Communicating key Audit matters in the independent Auditor's Matter , Key Audit Matters are those matters as per the Judgment of the Auditor are important in the audit of the financial statements.

The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

### **7(e) Energy Audit & Functions of energy Auditor:**

Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party.

*The following are some of the key functions of the energy auditor:*

- (i) Quantify energy costs and quantities.
- (ii) Correlate trends of production or activity to energy costs.
- (iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
- (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
- (v) Highlight areas that need attention for detailed investigations.
- (vi) Conduct preliminary and detailed energy audits which should include the following:
  - (a) Data collection and analysis.
  - (b) Measurements, mass and energy balances.
  - (c) Reviewing energy procurement practices.
  - (d) Identification of energy efficiency projects and techno-economic evaluation.
  - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
  - (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.