

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

Question No. 1 is compulsory

Answer any **four** out of remaining five questions.

#### Question 1

Answer the Following:

- (a) *William & Sons Limited is well-known in the hospitality and the entertainment industry with their chain of hotels, travel agencies etc.*

*They arrange packaged tours for customers both in India and abroad.*

*A snapshot of their financials for the previous year ended 31<sup>st</sup> March, 2020 is given below:*

Particulars	Amount in INR Mios	Remarks
Share Capital	5000	Includes fully convertible preference share capital (before 2021) of INR 2000 Mio
Reserves & surplus	200	Includes revaluation reserve of INR 100 Mio
External commercial borrowing	8800	No cover through hedging
Current Assets	2200	Primarily receivables from travel companies who were enjoying credit terms from the company
Current Liabilities	6550	Represents payments to creditors and banks
Property Plant Equipment (incl Goodwill of INR 2200 Mio)	11750	Goodwill has arisen based on the acquisition of hotels

*Their business has been severely impacted by COVID-19 pandemic during the period April to June 2020 and the Company has to submit its audited financial statements for the quarter ended 30 June 2020 to its investors. What are the key considerations to be taken into account whilst auditing the financial statements of the Company? (5 Marks)*

- (b) *Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. Risk based Audit (RBA) is an approach to audit that analyzes 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. What are the general steps for conducting Risk Based Audit? (5 Marks)*

- (c) *In the audit of ABC Private Limited, statutory auditor came across cases of payments to Directors, whereby expenses of a personal nature were reimbursed. As an auditor, how would you deal with the same?* **(4 Marks)**

**Answer**

- (a) **Key Audit Considerations to be taken into account whilst auditing the financial statements:** The financial statements have various items which would have been affected by the outbreak of COVID-19. In addition to the detailed list of items of financial statements mentioned in the situation, specific accounting issues could arise in the following areas:

1. Share Capital:
  - **Status of conversion** of Preference Share Capital and implication;
2. Reserve and Surplus:
  - 50% of the reserve is revaluation reserve which is **not free reserve**.
3. External Commercial borrowing :
  - Repayment capacity.
  - Forex impact.
  - Any restructuring / **change** in the terms of repayments to be checked.
4. Current Assets:
  - **Expected credit losses** on the receivables considering the industry in which the company operates. In the instant case current assets are primarily receivable from travel companies who were enjoying credit terms from the company and impact of Covid-19 on travel agency needs assessment.
  - **Inventory valuation**, if any inventory is lying with the company.
  - **Current ratio** assessment.
5. Current liabilities
  - **Repayment** capacity.
  - **Liquidity** position to be analysed.
6. Goodwill
  - **Impairment** assessment.
7. Property, Plant and Equipment:
  - **Impairment** assessment.
  - **Change in useful lives/** residual values.

In the given situation, on account of COVID-19 which has been prevailing, the liquidity position of the Company is under distress. The **auditor is required to discuss with the**

**management** as to how they are perceiving current and the near future position and thereafter assess the effect of estimation uncertainty or the risk assessment and audit evidence supporting these accounting estimates and related disclosures that may be affected by the impact of COVID-19 on the business of the entity and the economic environment. After assessment of the entire condition, the auditor may discuss **about the going concern position** of the company. The auditor is also required to **ensure disclosures to be given** in the financial statements are as per ICAI advisory.

(b) **General steps for conducting Risk Based Audit** : Risk Based Audit consists of **four main phases** starting with –

- (i) the identification and prioritization of risks,
- (ii) to the determination of residual risk,
- (iii) reduction of residual risk to acceptable level, and
- (iv) the reporting to auditee of audit results.

These are achieved through the following:

- A. 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 understanding agency operations.
- B. 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 Statutory Auditor 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.
- C. 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.
- D. 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.

**(c) Reimbursement of Personal Expenses of Director :**

- (i) All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorized both in accordance with the **Companies Act and Articles of Association of the company.**
- (ii) Articles may provide that such remuneration requires **sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors.**
- (iii) If the **terms of appointment of a Director** include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company.
- (iv) In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to **disclose the fact in his report, as also in the accounts.** In this regard attention is invited to **Section 143(1)(e) of the Companies Act, 2013** wherein auditor has to inquire into whether personal expenses have been charged to revenue.

**Question 2**

- (a) *You are being appointed as the auditor of X Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of materiality while auditing? (5 Marks)*
- (b) *The corporate responsibility under the SOX, 2002 and the Corporate Social Responsibility under the Companies Act, 2013 are referring to the same concept. Please evaluate this statement critically. (5 Marks)*
- (c) *Auditing virtually through remote working model has its own pros and cons for the Auditors. Elucidate any four pros and cons with reasons. (4 Marks)*

**Answer**

- (a) SA 320 “Materiality in Planning and Performing an Audit”** prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

As auditor of X Ltd., for determining the materiality level, factors that may affect the identification of an appropriate benchmark include the following:

- i. The **elements of the financial statements** (for example, assets, liabilities, equity, revenue, expenses);
- ii. Whether there are items on which the **attention of the users** of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue or net assets);
- iii. The **nature of the entity**, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- iv. The **entity's ownership structure and the way it is financed** (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- v. The **relative volatility** of the bench.

**(b) Corporate Responsibility under the SOX 2002 and the Corporate Responsibility under the Companies Act, 2013 – Referring to the same concept:**

The Sarbanes Oxley Act of 2002 established corporate accountability and civil and criminal penalties for white – collar crimes. The title three of SOX 2002 deals with the Corporate Responsibility whereas Section 135 of the Companies Act, 2013 deals with Corporate Social Responsibility. Both refer the same concepts such as:

- (i) More independence be given to Audit Committee and auditor.
- (ii) Strict reporting by an auditor on insider trading.
- (iii) Additional disclosures imposed on financial reporting.
- (iv) If there is any conflict between company and its auditor, the Audit Committee should be empowered to resolve the same.
- (v) Higher penalties and criminal prosecution on financial frauds.
- (vi) To include effectiveness of Internal Control System in the financial reporting.
- (vii) More responsibilities must be imposed on managerial personal with higher penalties and prosecutions on the breach.
- (viii) Strict action against white collar crime.
- (ix) Disclosers of the % of shareholdings by Directors, Executive Officers and principal shareholders.

In view of above, it can be concluded that Corporate Responsibility under SOX and Corporate Social Responsibility under Companies Act, 2013 are referring to the same concept.

**(c) Auditing Virtually through Remote Working Model -**

Auditing virtually has several benefits as well as disadvantages for the Auditors, the details of which are summarised as under

Particulars	Remarks
<b>Pros of auditing virtually through remote working model:</b>	
<b>Heightened use of Technology for better execution</b>	Virtual audit is possible only with the use of technology. Hence embracing technology helps in better audit delivery and in making auditors tech savvy to prepare for the future.
<b>Improved Audit Quality</b>	Use of technology helps in improving the audit quality.
<b>Greater Audit Coverage</b>	With the interplay of technology and the availability of quality time — the audit coverage could be enhanced significantly.
<b>Audit Efficiencies</b>	Through proper planning, upfront engagement with the client, audit efficiencies are possible.
<b>Lesser cost of delivery</b>	The cost of audit delivery would be comparatively lesser through remote working.
<b>Higher scalability</b>	The possibility of capacity ramp up is feasible without any restrictions on availability of space etc.
<b>High speed</b>	Information can be generated very quickly. Even complex reports in specific report format can be generated for audit purposes without much loss of time. This cuts down the time enabling the auditor to extend their analytical review with high speed of operation.
<b>Low clerical error</b>	Computerised operation being a systematic and sequential programmed course of action the chances of commission of error is considerably reduced. Clerical error is highly minimised.
<b>Concentration of duties</b>	Computer programs perform more than one set of activities at a time thereby restricting the duty of personnel involved in the work.
<b>Control distribution of the output and timely Corrections of errors</b>	Auditor being able to control distribution of the output and ensuring the timely correction of errors, for example, if the wrong input file were to be used.
<b>Cons of auditing virtually through remote working model:</b>	
<b>Lack of conclusive Evidence</b>	Aspects such as physical verification of inventory etc. requires physical presence and the same cannot be done virtually.
<b>High level of Dependency</b>	Dependency on technology and various infrastructure associated with it would pose challenges.

<b>Increased Time in Coordination</b>	Time spent in coordination is very high.
<b>Security and compliance issues</b>	The entire audit process is carried out with the help of technology which is prone to various security concerns. Further, aspects relating to confidentiality, data protection etc. are very critical for a successful virtual audits. Further, the possibility of nonidentification of frauds/ reliance on fake scanned documents etc. is very high in a virtual audit environment.
<b>Feel of Audit and Client engagement</b>	In the absence of face to face interactions, the real feel of the audit and the client engagement could be a challenge.
<b>Non-availability of sufficient IT knowledge and expertise:</b>	The audit team should have sufficient knowledge to plan, execute and use the results of the same. In the absence of sufficient knowledge it would be difficult to audit through remote working model.
<b>Non-availability of suitable computer facilities and data in suitable format:</b>	The auditor may plan to use other computer facilities when the use of remote working model on an entity's computer is uneconomical or impractical, for example, because of an incompatibility between the auditor's package programme and entity's computer.
<b>Impracticability of manual tests due to lack of evidence:</b>	Some audit procedures may not be possible to perform manually because they rely on complex processing (for example, advanced statistical analysis) or involve, amounts of data that would overwhelm any manual procedure.
<b>Time constraints in certain data</b>	Time constraints in certain data, such as transaction details, are often kept for a short time and may not be available in machine-readable form by the time auditor wants them. Thus, the auditor will need to make arrangements for the retention of data required, or may need to alter the timing of the work that requires such data.

**Question 3**

- (a) *For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. Explain the circumstances under which risk can arise or change.* **(5 Marks)**

- (b) *M/s ABC & Co., a firm of Chartered Accountants responded to a tender from a State Government for appointment of GST Auditor wherein no minimum fee was prescribed. For this purpose, the firm also paid ₹ 50,000 as earnest deposit as part of the terms of the tender. Comment on the above with reference to the Chartered Accountants Act, 1949, Code of Ethics and Schedules to the Act. (5 Marks)*
- (c) *T & Co, a firm of Chartered Accountants has not revised the terms of engagements and obtained confirmation from the clients for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement. (4 Marks)*

**Answer 3**

- (a) **Entity's Risk Assessment Process:** Risks can arise or change due to circumstances such as the following-
- (i) **Changes in operating environment.** Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
  - (ii) **New personnel.** New personnel may have a different focus on or understanding of internal control.
  - (iii) **New or revamped information systems.** Significant and rapid changes in information systems can change the risk relating to internal control.
  - (iv) **Rapid growth.** Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
  - (v) **New technology.** Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
  - (vi) **New business models, products, or activities.** Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
  - (vii) **Corporate restructurings.** Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
  - (viii) **Expanded foreign operations.** The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
  - (ix) **New accounting pronouncements.** Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.
- (b) **Responding to Tenders:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down Guidelines for responding to tenders, etc.
- As per the Guideline issued by the Council of the Institute of Chartered Accountants of

India, a member of the Institute in practice shall not respond to any tender issued by an organization or user of professional services in areas of services which are exclusively reserved for chartered accountants, such as audit and attestation services.

However, such restriction shall not be applicable where minimum fee of the assignment is prescribed in the tender document itself or where the areas are open to other professionals along with the Chartered Accountants. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

M/S ABC & Co., a firm of Chartered Accountants responded to a tender from a State Government for appoint of GST Auditor and for this purpose, the firm also paid ₹ 50,000 as earnest deposit as part of the terms of the tender.

In the instance case, since GST Audit does not fall within exclusive areas for chartered accountants, M/S ABC & Co can respond to tender as well as deposit ₹ 50,000 as earnest deposit and shall not have committed any professional misconduct.

- (c) **Circumstances that may Warrant the Revision in Terms of Engagement** : As per **SA 210 on “Agreeing the Terms of Audit Engagements”**, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
- (i) Any indication that the entity misunderstands the objective and scope of the audit.
  - (ii) Any revised or special terms of the audit engagement.
  - (iii) A recent change of senior management.
  - (iv) A significant change in ownership.
  - (v) A significant change in nature or size of the entity’s business.
  - (vi) A change in legal or regulatory requirements.
  - (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
  - (viii) A change in other reporting requirements.

#### **Question 4**

- (a) *TBR Limited has plan of its business being closed due to huge loss incurred due to the recent outbreak of global pandemic, within a short period from the close of the accounting year ended on 31st March, 2020. The Financial Statements for the said year have been prepared on the same basis as in earlier periods with an additional note that the business of the Company shall cease in near future and the assets shall be disposed off in accordance with a plan of disposal as decided by the Management. The Statutory Auditors of the Company indicated this aspect in Key Audit Matters only by a reference as to a possible cessation of business and making of adjustments, if any, to be made at the time*

of cessation only. Comment on the reporting by the Statutory Auditor as above.

(5 Marks)

- (b) XYZ Limited has prepared the financial statements for the year 2019-20 and mentioned in the significant accounting policies that depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management. The company has ignored the useful life of the assets mentioned in Schedule II of the Companies Act, 2013. As a statutory auditor of the company how would you deal with this? (5 Marks)
- (c) What are the professional obligations of the statutory auditor who has resigned before completion of his term due to non co-operation of the Management in completing certain audit procedures? (4 Marks)

#### Answer 4

- (a) **Closure of Business; Key Audit Matters** : As per SA 570 "Going Concern", management intentions to liquidate the entity or to cease operations is one of the events or conditions that may cast significant doubt on the entity's ability to continue as going concern.

As per SA 570, if events or conditions have been identified that may **cast significant doubt on the entity's ability** to continue as a going concern but, based on the audit evidence obtained, the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

Further, as per SA 701 "Communicating Key Audit Matters in the Independent Auditor's Report", when matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a Key Audit Matter. SA 701 also puts emphasis on auditor's responsibility to communicate Key Audit Matters in the auditor's report.

As per the facts given in the case, intention of TBR Limited has a plan of its business being closed as huge loss is incurred due to the recent outbreak of global pandemic, within short period from 31<sup>st</sup> March 2020. However, financial statements for the year ended 31.03.2020 have been prepared on the same basis as it had been in earlier periods with an additional note.

Thus, management's intention to liquidate the entity or to cease operations is one of the events or conditions that may cast significant doubt on the entity's ability to continue as going concern is a Key Audit Matter. Therefore, the **auditor is required to Communicate the Key Audit Matters** in accordance with SA 570 in the above stated manner. Simple reference as to a possible cessation of business and making of adjustments, if any, he made at the time of cessation only by the auditor in his report is not sufficient.

- (b) **Providing Depreciation ignoring Schedule II to the Companies Act, 2013: Section 129 of the Companies Act, 2013**, requires that the financial statements shall give a true and fair view of the state of affairs of the company and are in compliance with Accounting Standards.

Further, as per **Schedule II to the Companies Act, 2013 on 'Useful Lives to Compute Depreciation'**, the useful life of an asset shall not ordinarily be different from the useful life specified therein. However, if such a company uses a useful life of the asset which is different from the above limits, it **shall disclose the justification for the same in its financial statement**.

In the given case, M/S XYZ Limited has mentioned in the significant accounting policies that the depreciation on tangible fixed assets is provided on the straight line method over the useful lives of the assets as estimated by the management and ignored the useful lives of the assets as, provided under Schedule II to the Companies Act, 2013.

Therefore, the statutory **auditor of the company should ensure** that the management has disclosed the justification for consideration of different useful life of the assets from that as indicated under Schedule II. If the justification has not been provided then the auditor of the company shall suggest to the management for the same and if the management refuses, the **auditor should qualify his report** accordingly.

- (c) **Resignation Due to Management Imposing Limitation on the Scope of Audit : SA 705 "Modifications to the Opinion in the Independent Auditor's Report"** provides the consequence of an inability to obtain sufficient appropriate audit evidence due to a management - imposed limitation after the auditor has accepted the engagement. The practicability of resigning from the audit may **depend upon the stage of completion of the engagement** at the time that management Imposes the scope limitation.

When the auditor concludes that resignation from the audit is necessary because of a scope limitation, there may be a **professional, regulatory or legal requirement** for the auditor to communicate matters relating to the resignation from the engagement to regulators or the entity's owners.

In the case of resignation from the company, provisions of the Companies Act, 2013 apply. **Section 140(2) of the Companies Act, 2013**, requires the auditor, who has resigned from the company **to file within a period of 30 days**. from the date of resignation, **a statement with the company and the registrar**, and in case of government companies, the auditor shall file such statement with the **Comptroller and Auditor-General of India**, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor will be **liable for penal provisions**.

#### Question 5

- (a) *A firm of Chartered Accountants was appointed by a company to evaluate the costs of the various products manufactured by it for its information system. One of the partners of the firm was a Non-Executive Director of the company. Comment with reference to the*

*Chartered Accountants Act, 1949 and Schedules thereto.*

**(5 Marks)**

(b) *Mr. BK, Partner in M/s. BK and Associates, as part of their audit presentation to the Audit Committee of M/s. XYZ Limited, a listed company, highlighted the following:*

- *Difficulties faced during the audit*
- *Disagreements with the management*
- *Management Letter Points*
- *Draft Management Representation letter to be provided by the Company in connection with the audit.*

*Some of the Audit Committee members were not happy with the above presentation and asked Mr. BK to take it back and submit directly to the Board. They believe that Audit Committee is not the forum for discussing such problems and this has to be sorted out between auditors and the management. Please comment on the above.* **(5 Marks)**

(c) *G Ltd. changed its employee remuneration policy from 1<sup>st</sup> April, 2019 to provide for 12% contribution to provident fund on leave encashment also. As per the leave encashment policy, the employees can either utilize or encash it. As at 31<sup>st</sup> March, 2020, the company obtained an actuarial valuation for leave encashment liability. However, it did not provide for 12% PF contribution on it. The auditor of the company wants it to be provided but the management replied that as and when the employees availed leave encashment, the provident fund contribution was made. The company further contends that this is the correct treatment as it is not sure whether the employees will avail leave encashment or utilize it. Comment.* **(4 Marks)**

**Answer**

(a) **Evaluation of Cost of Products: Clause (4) of Part I of the Second Schedule** to Chartered Accountants Act, 1949, states that expressing an opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has a substantial interest would constitute misconduct.

Also, the **Council of the Institute of Chartered Accountants of India** has stated that in cases where a member of the Institute is a director of a company, or the firm in which the said member is a partner, he should not express any opinion on its financial statements.

As per facts of the case, the firm has been retained to evaluate the cost of products manufactured by it for its information system. It is a part of management consultancy service of the firm and, moreover, its partner was on the Board.

Hence, the **firm can perform this assignment and it will not constitute misconduct.** However, the firm while accepting the position as auditor in future would have to consider whether it would be possible to act in an independent manner and express opinion on financial statements.

(b) **Mandatory Review Areas of Audit Committee:** As per the Auditing Standards, the

statutory auditor of the Company is having an obligation to bring certain matters to the attention of those in charge of governance, which inter alia includes aspects such as -

- Difficulties faced by them during the audit
- Disagreements with the management
- Management Letter Points
- Draft Management Representation letter to be provided by the Company in connection with the audit.

Further, the Audit Committee is also having an obligation to mandatorily review certain areas before providing their recommendations/inputs to the board.

Given below are the areas required to be mandatorily reviewed by the ACM in the case of listed companies.

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

- (i) Management discussion and analysis of financial condition and results of operations;
- (ii) Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;
- (iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;
- (iv) Internal audit reports relating to internal control weaknesses;

The auditor should further ascertain whether the Management Discussion and Analysis report includes discussion on the matters stipulated. Where certain deficiencies or adverse findings are noted by the Audit Committee, the auditor will be required to see that these have been suitably dealt with by the management in the report on corporate governance.

In the instant case, Mr. BK, Partner in M/s BK and Associates highlighted the facts such as difficulties faced during the audit, disagreements with the management, managements letters points and draft management letters to be provided by the Company in connection with the audit. However, some of the audit committee members were not happy and as according to them audit committee is not the forum for discussing such problems.

Contention of those audit committee members regarding problems to be sorted out between auditors and the management is not in order as Audit Committee is required to mandatorily review the same in accordance with Schedule II of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

- (c) **Change of Employee Remuneration Policy-PF on Leave Encashment:** As per Para 11 of AS-15 on "Employee Benefits", issued by the Institute of Chartered Accountants of India, an enterprise should recognize the expected cost of short-term employee benefits in the form of compensated absences in the case of accumulating compensated absences,

when the employees render service that increases their entitlement to future compensated absences.

In the given situation, G Ltd. has changed its employee remuneration policy from April 1, 2019 regarding providing for 12% contribution to PF on leave encashment.

Since the company obtained actuarial valuation for leave encashment, it is obvious that the **compensated absences are accumulating in nature**. An enterprise should measure the expected cost of accumulating compensated absences as the additional amount that the enterprise expects to pay as a result of the unused entitlement that has accumulated at the balance sheet date.

Here, G Ltd. will accumulate the amount of leave encashment benefits as it is the **liability of the company to provide 12% PF** on amount of leave encashment. Hence the **contention of the auditor is correct** that full provision should be made by the company.

#### Question 6

- (a) *Tiger Ltd. has applied to a bank for loan facilities. The bank on studying the financial statements of the company notices some discrepancies in the books of the company. Upon discussion with the auditor of the company, the bank manager requested for detailed information regarding a few items in the financial statements. The information is available in the working paper file of the auditor. What should be the response of the auditor in this regard?* **(5 Marks)**
- (b) *CA. M, appointed as a Peer Reviewer for M/s. K Associates, has asked for all the compilation and the Due Diligence engagements carried out by M/s. K Associates for her peer review during the period considered for peer review purposes by the board. She has also sent out a mail to Peer Review Board regarding her selection. Mr. K, the managing partner of the firm seeks your advise on this matter.* **(5 Marks)**
- (c) *ABC Limited which deals with consumer products has extensively automated all its operations including the accounting operations. The automation involves ERP, Robotic process automation, Analytics etc.*

*You are required to audit the entity duly considering the inherent and control risk for material financial statement assertions. Elucidate the key areas that you will focus on for identifying risks including the deficiencies.* **(4 Marks)**

OR

*A company has disclosed its old CNC machines as assets held for sales under inventories in its annual financial statements and has also included the net realizable value of the same as part of working capital statements to the banks. Please comment on appropriateness of the above treatment from a statutory auditor point of view.*

**Answer**

- (a) **Divulge Information obtained in the course of audit: Clause (1) of Part I of the Second Schedule to the Chartered Accountants Act, 1949** states that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of the client or otherwise than as required by law for the time being in force.

**SA 200 on “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”** also reiterates that, "the auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose".

In the instant case, Tiger Ltd. has applied to a bank for loan facilities and the bank has asked the auditor for detailed information regarding few items in the financial statements available in his working papers. Having regard to the position stated earlier, **the auditor cannot disclose the information** in his possession without specific permission of the client.

As far as working papers are concerned, **working papers are the property of the auditor**. The auditor may at his discretion, make portions of or extracts from his working papers available to his client". Thus, there is **no requirement compelling the auditor to divulge information** obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

Thus, in the instant case, auditor of Tiger Ltd., **after consulting with client, may provide the details to bank** based on the working papers maintained by him.

- (b) **Selection of Assurance Service Engagements for Review:** The Statement on Peer Review defines the scope of peer review which revolves around compliance with **technical, ethical and professional standards**; quality of reporting; office systems and procedures with regard to compliance of assurance engagements; and, training programmes for staff including articled and audit assistants involved in assurance engagements. The **entire peer review process is directed at the assurance services**.

Assurance Services means assurance engagements services as specified in the **“Framework for Assurance Engagements”** issued by the Institute of Chartered Accountants of India and as may be amended from time to time. Assurance engagements **does not include** engagements for the compilation of financial statements **or** engagements solely to assist the client in preparing, compiling or collating information other than financial statements; **or** engagement for Due diligence.

In the given situation, CA. M is appointed as a peer reviewer for M/s K Associates, has asked for all the compilations and the due diligence engagements carried out by M/s K Associates for her peer review. In view of above, Peer Review of compilation and due

diligence at the time of execution step by **CA. M is not correct as due diligence and compilation engagements are not covered** in the scope of Assurance engagement and Peer Review is directed at assurance engagement only.

- (c) **Risk Assessment – CIS Environment:** The auditor in accordance with **SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”**, should make an assessment of Inherent and Control risk for material financial statement assertions.

In a CIS environment the risk of a Material financial statement assertion being erroneously stated could arise from the deficiencies in the following case as

- (i) Program Development and maintenance.
- (ii) System software support.
- (iii) Operations including processing of data.
- (iv) Physical CIS security.
- (v) Control over access to specialized utility program.

These deficiencies would **tend to have a negative impact** on all application systems that are processed through the computer.

**OR**

- (c) **Assets held for Sale – Appropriateness of Treatment : As per AS 2 – “Valuation of Inventories”**, inventories are assets:(i) held for sale in the ordinary course of business; (ii) in the process of production for such sale; or (iii) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Further, inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per **AS 10, Property, Plant and Equipment**. Such items are accounted for in accordance with Accounting Standard (AS) 10, Property, Plant and Equipment.

In the instant case, disclosure of CNC machines as assets held for sale under inventories by company in its annual financial statements **is not in compliance with Accounting Standards 2 and AS 10**. Further, Company has also included the net realizable value of those CNC machines as part of working capital statements to the banks.

Thus, **accounting treatment of CNC Machines is not correct** here as assets held for sale should be shown separately but not under Inventories. Further, statutory auditor would check the materiality and accordingly consider the reporting implications.