

Note: All questions are compulsory.

Question 1

Power of Tribunal in case Auditor acted in a Fraudulent Manner:

- As per sub- section (5) of the section 140 of the Companies Act, 2013, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors. **(2 Marks)**
- However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place. **(2 Marks)**
- It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447 of the said Act. **(2 Marks)**
- It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers. **(2 Marks)**

Question 2 a (4 marks)

Reporting to Shareholders	Reporting to those Charged with Governance	
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.	Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.	2 marks
Statutory Audit Report is on true and fair view and as per prescribed Format.	It is a reporting on matters those charged with governance like scope of audit, audit procedures audit modifications, etc	1 mark
Statutory Audit Reports are in public domain.	Reporting to those Charged with Governance is an internal document i.e. private report.	1 mark

b (4 marks)

Audit Qualification	Emphasis of Matter	
Standard on Auditing 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification	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	1 mark
Audit Qualifications are also known as "subject to report" or "except that report".	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	1 mark
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.	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.	2 marks

Question 3

a. Statutory Liquidity Ratio (SLR) Requirements: The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a financial year not being Fridays. The resultant report is to be sent to the top management of the bank and to the Reserve Bank. The report of the statutory auditors in relation to compliance with SLR requirements has to cover two aspects-

- correctness of the compilation of DTL (Demand and Time Liabilities) position; and
- maintenance of liquid assets.

(1 Mark)

b. Audit Approach and Procedure:

- i. Obtain an understanding of the relevant circulars of the RBI, particularly regarding composition of items of DTL. **(1/2 Mark)**
- ii. Require the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates. **(1/2 Mark)**
- iii. Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI. **(1/2 Mark)**
- iv. While examining the computation of DTL, specifically examine that the following items have been excluded from liabilities- **(1 Mark)**

- Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
 - Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.
 - Un-adjusted deposits/balances lying in link branches for agency business like dividend warrants, interest warrants, refund of application money, etc., in respect of shares/debentures to the extent of payment made by other branches but not adjusted by the link branches.
 - Margins held and kept in sundry deposits for funded facilities-
- v. Similarly, specifically examine that the following items have been included in liabilities-**(1 Mark)**
- Net credit balance in branch adjustment accounts including these relating to foreign branches. Interest on deposit as at the end of the firm half year reversed in the beginning of the next half-year.
 - Borrowings from abroad by banks in India needs to be considered as 'liabilities to other' and thus, needs to be considered at gross level unlike 'liabilities towards banking system in India', which are permitted to be netted off against 'assets towards banking system in India'. Thus, the adverse balances in Nostro Mirror Account needs to be considered as 'Liabilities to other'
 - The reconciliation of Nostro accounts (with Nostro Mirror Accounts) needs to be scrutinized carefully to analyze and ascertain if any inwards remittances are received on behalf of the customers / constituents of the bank and have remained unaccounted and / or any other debit (inward) entries have remained unaccounted and are pertaining to any liabilities for the bank.
- vi. Examine whether the consolidations prepared by the bank include the relevant information in respect of all the branches. **(1/2 Mark)**
- vii. It may be noted that, even though interest accrues on a daily basis, it is recorded in the books only at periodic intervals. Thus, examine whether such interest accrued but not accounted for in books is included in the computation of DTL. **(1/2 Mark)**
- viii. The auditor at the central level should apply the audit procedures listed above to the overall consolidation prepared for the bank as a whole. Where such procedure is followed, the central auditor should adequately describe the same in his report. **(1/4 Mark)**
- ix. While reporting on compliance with SLR requirements, the auditor should specify the number of unaudited branches and state that he has relied on the returns received from the unaudited branches in forming his opinion. Recently, there has been introduction of Automated Data Flow (ADF) for CRR & SLR reporting and the auditors should develop necessary audit procedures around this. **(1/4 Mark)**

Question 4

Non-cash Transactions with Relative of Director: As per Clause (xv) of 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". **(1 mark)**

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. **(1 mark)**

In the instant case, RNT Ltd. has entered into non-cash transactions with Mr. Ram, son of one of the directors, which is an arrangement by which RNT 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. **(1 mark)**

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. **(1 mark)**

In the given situation, RNT Ltd. has entered into non-cash transactions with Mr. Ram, 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:

According to the information and explanations given to us, RNT Ltd. has entered into non-cash transactions with Mr. Ram, 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. **(2 marks)**

Question 5

Decline in Net Profits despite Increasing Sales: As per the facts that there has been consistently high turnover but declining net profits is an anomalous situation. It may be attributed to one or more following reasons requiring further investigation-

- (i) **Unfavourable Sales mix:** Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced despite an increase in sales. **(1 Mark)**
- (ii) **Negative Impact of Financial Leverage:** Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits. **(1 Mark)**
- (iii) **Other Items included in Sales:** The figure of sales as per Statement of Profit and Loss may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value. **(1 Mark)**
- (iv) **High Administrative and Selling Expenses:** Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales. **(1 Mark)**
- (v) **Cost-Price Relationship:** If the increases in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost. **(1 Mark)**
- (vi) **Competitive Price:** Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run. **(1/2 Mark)**
- (vii) **Additions to Fixed Assets:** Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales. **(1/2 Mark)**

Question 6

(a) Due Diligence – Key Areas: (4 marks) The Japanese company engaged in the business of manufacturing and distribution of industrial gases wishing to acquire a listed Indian company has commissioned the Due Diligence Audit to assess the strengths and weaknesses of this company. It is quite important for the acquirer to assess the proposal from different angles and specifically as per terms of the assignment and also see whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on

the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the legal aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate. In any case, it is quite important to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired. Some of the significant key areas which shall be covered under the review are as under:

- (1) Historical Background:** The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the company may reveal its turning points, survival strategies adopted from time to time, the market share enjoyed by and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the said company. This could, inter alia, include the nature of business(es), location of production facilities, warehouses, offices, products or services and markets.
- (2) Significant Accounting Policies:** The accounting policies being followed by the company and the appropriateness thereof is another key area. The impact of the recent changes in the accounting policies in the recent past keeping in view its intention of offering itself for sale. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is also quite important to ascertain significant accounting policies used by the company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the company are different from those adopted by the acquiring enterprise and the effect of such differences. Finally, examine whether the financial statements of the company have been prepared in accordance with the governing statutory requirements.
- (3) Review of Financial Statements:** An evaluation of the profit reported by the company would be largely based upon its operating results. Any extraordinary item of income or expense that might have affected the operating results would require close examination. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. The exercise to evaluate the balance sheet of the company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.
- (4) Cash Flow:** A review of historical cash flows and their pattern would reflect the cash generating abilities of the company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements

through internal accruals or does it have to seek external help from time to time. It is necessary to check:

- (a) Whether the company is able to honour its commitments to its trade payables, to the banks, to government and other stakeholders;
- (b) How well is the company able to turn its trade receivables and inventories;
- (c) How well does it deploy its funds; and
- (d) Whether any funds are lying idle or is the company able to reap maximum benefits out of the available funds.

(5) Financial Projections: The projections for the next five years with detailed assumptions and workings and the appropriateness of assumption used in the preparation and presentation of financial projections. If the accountant is of the opinion that as assumption used by the company are unrealistic, the accountant should consider its impact on the overall valuation of the company.

(6) Human Resources: In the Indian context, the status of work force, staff and employees is a complex problem. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. The aspects whether all employee benefits like PF, Gratuity, ESI and superannuation have been properly paid/funded. The pay packages of the key employees will be thoroughly reviewed since this can be a crucial factor in future employee costs.

(7) Statutory Compliance: This is one area that has to be examined in detail. It is important to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance, it could lead to punitive charges under the law. The impact on such violations be quantified and assessed in respect of entity; financial status and even on its governing concern status.

b Contents of a Due Diligence Report: Briefly, the contents of a due diligence report can be discussed under: **(4 marks)**

- ☐ Terms of reference and scope of verification.
 - ☐ Objective of due diligence.
 - ☐ Brief history of the company including shareholding pattern.
 - ☐ Assessment of management structure.
 - ☐ Assessment of financial liabilities with special emphasis on Interlocking investments and financial obligations with group/associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
 - ☐ Assessment of valuation of assets including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.
 - ☐ Assessment of operating results.
 - ☐ Assessment of taxation and statutory liabilities.
 - ☐ Assessment of possible liabilities on account of litigation and legal proceedings against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
 - ☐ Assessment of net worth.
- c Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.

d Status of franchises, license and patents.

Finally, an executive summary may be prepared highlighting the significant areas.

Question 7:

a. Contract Notes: (4 marks)

Contract note is a document through which a contractual obligation is established between a member and a client. Every member of the stock-exchange has to issue contract notes to his clients for the trades executed on their behalf. The contract notes are required to be issued to the Client within 24 hours of execution of the trades. Members are also required to preserve counter-foils or duplicates of the copies of contract notes issued to clients. The member is also required to maintain written consent of clients for the contracts entered into as Principal. Contract notes issued to clients should show the brokerage separately. The total brokerage charged by the member should not exceed the specified value of the trade. It may be noted that the brokerage percentage is prescribed from time to time. The Contract Notes are required to be signed either by the member himself or his constituted attorney. In case of a sole proprietor / partnership firm wishes to authorise another person to sign the contract notes, then the member is required to submit a power of attorney to the Exchange. In case of corporate membership, a board resolution is required to authorise a person including Directors to sign the contract notes.

The member then prepares a Contract Note in the prescribed form after adding the brokerage and sends the original Contract Note to the client. The auditor should evaluate the internal control procedures instituted by the stock broker for proper maintenance and issuance of contract notes. The auditor should verify that the transactions done by a member are recorded in the sauda book. It should also be examined that contract notes are issued for all the business conducted on behalf of the clients. The auditor should verify the list of trades executed with the bills raised. The auditor should apply appropriate audit procedures to satisfy himself that -

- (i) Contract notes have been serially numbered.
- (ii) No serial number has been left blank.
- (iii) Format of the Contract Note is as prescribed by the Regulations of the Exchange.
- (iv) Duplicate copies / counterfoils of contract notes are maintained.
- (v) Brokerage charged in contract notes is within the permissible limits and is indicated separately including service tax.
- (vi) Contract notes have been signed by an authorised person.
- (vii) Contract notes have been issued in respect of all transactions.
- (viii) Transaction Identification, Trade Identification and Trade Execution time has been printed on the contract note issued.
- (ix) SEBI Registration number, Settlement number, Settlement dates have been mentioned.
- (x) PAN number of the member and client has been mentioned on Contract Note where if required.
- (xi) All clauses specified by the Exchange have been printed on the reverse of the contract notes.

b. Suda Book: (4 marks)

All members are required to maintain a 'Suda Book', which contains details of all deals transacted by them on a day to day basis. This is a basic record, which each member is required to maintain regularly on day-to-day basis. It contains the details regarding the name of the code of the client on whose behalf the deals have been done, rate and quantity of bought or sold. These details are maintained date wise. This register contains all the transactions, which may be of any of the kind mentioned below:

- a. member's own business on the Exchange;

- b. member's business on the Exchange on behalf of clients;
- c. member's business with the clients on principal-to-principal basis;
- d. member's business with the members of other Stock Exchanges;
- e. member's business on behalf of his clients with the members of other Stock Exchanges;
- f. Spot transactions, etc.
