J.K. SHAH TEST SERIES
Evaluate Learn Succeed

FINAL – November 2017

PAPER 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

Test Code – PR 3
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Note: *Question No.* ***1*** *is compulsory. Answer any* ***five*** *from the rest*

Question 1

a. **Additional Audit Procedures When Events or Conditions Are Identified:** As per SA 570 "Going Concern", when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. **(1 mark)**

These procedures shall include:

(i) When management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment. **(1 mark)**

(ii) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances. **(1 mark)**

(iii) When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action: **(1 mark)**

(1) Evaluating the reliability of the underlying data generated to prepare the forecast; and

(2) Determining whether there is adequate support for the assumptions underlying the forecast.

(iv) Considering whether any additional facts or information have become available since the date on which management made its assessment. **(1/2 mark)**

(v) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans. **(1/2 mark)**

b. **Auditor to make Inquiries regarding Management's own Assessment of Risk of Fraud and Controls:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. **(2 marks)**

In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control. **(1 mark)**

The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. **(1 mark)**

Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information. **(1 mark)**

c. **When the Parent's Auditor is not the Auditor of all its Components:** In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of **SA 600 "Using the Work of Another Auditor". (1 mark)**

As per SA 706, When the parent's auditor decides that he will make reference to the audit of the other auditors, the auditor's report on consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). **(1 mark)**

This may be done by stating aggregate rupee amounts or percentages of total assets and total revenues and cash flows of subsidiary(s) included in consolidated financial statements not audited by the parent's auditor. **(1 mark)**

Total assets, revenues and cash flows not audited by the parent's auditor should be presented before giving effect to permanent and current period consolidated adjustments. **(1 mark)**

However, reference in the report of the auditor of consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries. **(1 mark)**

d. **Factors Affecting Acceptance and Continuance of Client Relationships and Review Engagements:** As per SRE 2400 "Engagements to Review Historical Financial Statements", unless required by law or regulation, the practitioner shall not accept a review engagement if-

   a. The practitioner is not satisfied:

      i. that there is a rational purpose for the engagement; or

      ii. that a review engagement would be appropriate in the circumstances; **(1 mark)**

   b. The practitioner has reason to believe that relevant ethical requirements, including independence, will not be satisfied; **(1 mark)**

   c. The practitioner's preliminary understanding of the engagement circumstances indicate that information needed to perform the review engagement is likely to be unavailable or unreliable; **(1 mark)**

   d. The practitioner has cause to doubt management's integrity such that it is likely to affect proper performance of the review; or**(1 mark)**

   e. Management or those charged with governance impose a limitation on the scope of the practitioner's work in the terms of a proposed review engagement such that the practitioner believes the limitation will result in the practitioner disclaiming a conclusion on the financial statements. **(1 mark)**

Question 2

a. **Formulation of Audit Strategy:** While formulating the audit strategy for a company, following factors may be considered -

General Factors: (2 marks)

(i) The engagement objectives.

(ii) The results of the business review, including major developments in the client's business and industry, significant operating results and financial arrangements.

(iii) Preliminary judgements as to materiality.

(iv) Identified inherent risks. The team should also consider the risk of fraud and, in particular, any evidence of a high level of risk to the firm. They should take into account the results of procedures for the acceptance and continuation of clients.

(v) The degree to which the team should carry out further assessment of controls as a means of reducing substantive tests.

(vi) The broad nature, extent and timing of substantive tests, or changes to the previous year's strategy for substantive testing.

(vii) Main points relating to planning and controlling the audit or comments on the adequacy of the existing arrangements.

Specific Factors for Online Shopping: (3 marks)

The auditor shall also obtain an understanding of the information system including the related business processes due to new venture of online shopping in the following areas:

(i) The classes of transactions in the entity's operations that are significant to the financial statements;

(ii) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as

necessary, transferred to the general ledger and reported in the financial statements;

(iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

(iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

(v) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

b. Basic system of Control: Internal Checks and Internal Audit are important constituents of Accounting Controls. Internal check system implies organization of the overall system of book-keeping and arrangement of staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.

In the given case of New Life Hospital, the person- in-charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. Thus, one of the basic system of control i.e. internal check which includes segregation of duties or maker and checker has been violated where transaction processing is allocated to different persons in such a manner that no one person can carry through the completion of a transaction from start to finish or the work of one person is made complimentary to the work of another person. **(1 mark)**

The general conditions pertaining to the internal check system may be summarized as under- **(4 marks)**

(i) No single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) There should exist an accounting control in respect of each class of assets, in addition, there should be periodical inspection so as to establish their physical condition.

(vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised and wide deviations observed should be reconciled.

(viii) For inventory taking, at the close of the year, trading activities should, if possible be suspended, and it should be done by staff belonging to several sections of the organization.

(ix) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which those are actually exercised should be reviewed periodically.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

c. **(a) Auditing procedures using CAATs:** CAATs may be used in performing various auditing procedures, including the following: **(3 marks)**

i. Tests of details of transactions and balances, for example, the use of audit software for recalculating interest or the extraction of invoices over a certain value from computer records;

ii. Analytical procedures, for example, identifying inconsistencies or significant fluctuations;

iii. Tests of general controls, for example, testing the set-up or configuration of the operating system or access procedures to the program libraries or by using code comparison software to check that the version of the program in use is the version approved by management;

iv. Sampling programs to extract data for audit testing;

v. Tests of application controls, for example, testing the functioning of a programmed control; and

vi. Re-performing calculations performed by the entity's accounting systems.

(b) **Consideration of Factors in Use of CAATs:** In determining whether to use CAATs, the auditor should consider the following factors: **(3 marks)**

(i) **Availability of sufficient IT knowledge and expertise**: It is essential that members of the audit team should possess sufficient knowledge and experience to plan, execute and use the results of CAAT. The audit team should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted.

(ii) **Availability of CAATs and suitable computer facilities and data in suitable format**: The auditor may plan to use other computer facilities when the use of CAATs 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.

(iii) **Impracticability of manual tests due to lack of evidence**: 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.

(iv) **Impact on effectiveness and efficiency in extracting a data**: It includes selection of samples, applying analytical procedures, time involved in application of CAAT, etc.

(v) **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.

(i) Appointment of First Auditor: Provisions of the Companies Act, 2013 relating to appointment of first auditor are stated below-

a. **Appointment of First Auditor in the case of a company, other than a Government Company- (1 ½ marks)**

As per Section 139(6), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

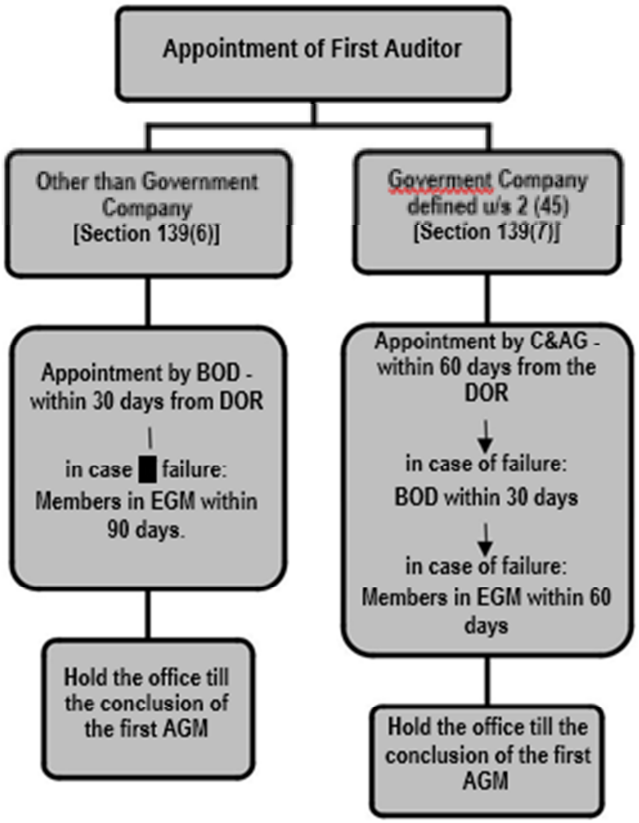
In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

b. **Appointment of First Auditor in the case of Government Company- (1 ½ marks)**

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.



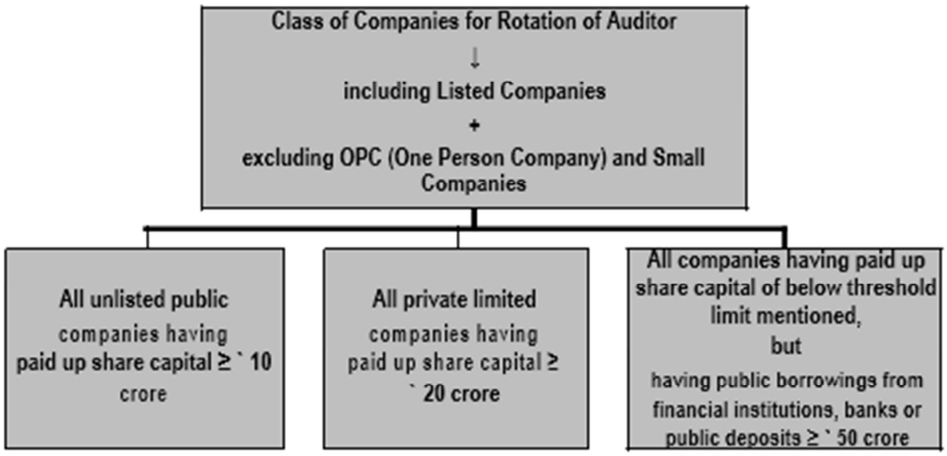
(ii) Appointment of First Auditor by the Managing Director: (2 marks)

Apparently, there are two issues arising out of the situation given in the question, viz., first one relates to appointment of first auditor by the Managing Director; and second pertains to relation of such an auditor with the Managing Director. Regarding the first issue relating to appointment of auditor, particularly, in this case relating to appointment of first auditor, it may be noted that as per the provisions of section 139(6) of the Companies Act, 2013, the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

As per the facts given in the case, the appointment of CA Rajnath as first auditor by the Managing Director of Malta Pvt. Ltd. by himself is in violation of section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company.

Thus, the appointment of CA Rajnath is not valid. Under the circumstances, the second issue relating to relationship of auditor with Managing Director becomes redundant.

b. Rotation of Auditor & Cooling Off Period Provisions: The provisions related to Rotation of Auditor & Cooling Off Period are newly inserted by section 139(2) of the Companies Act, 2013 read with Rule 5 of the Companies (Audit & Auditors) Rules, 2014, which are discussed as under:



The provisions related to rotation of auditor are applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014, which prescribes the following classes of companies excluding one person companies and small companies, namely:-

(i) all unlisted public companies having paid up share capital of ` 10 crore or more;

(ii) all private limited companies having paid up share capital of ` 20 crore or more;

(iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ` 50 crores or more.

As per Section 139(2) of the Companies Act, 2013, no listed company or a company belonging to such class or classes of companies as mentioned above, shall appoint or re-appoint-

(a) an individual as auditor for more than one term of 5 consecutive years; and
(b) an audit firm as auditor for more than two terms of 5 consecutive years.

(2 marks)

In the given case, Apple Ltd. is an unlisted public company having paid up share capital of ` 5 crore and public deposits of ` 100 crore. The company has appointed M/s Pear & Co., a chartered accountant firm, as the statutory auditor in its AGM held at the end of September, 2016 for 11 years.

The provisions relating to rotation of auditor will be applicable as the public deposits exceeds ` 50 crore. Therefore, Apple Ltd. can appoint M/s Pear & Co. as an auditor of the company for not more than one term of five consecutive years twice i.e. M/s Pear & Co. shall hold office from the conclusion of this meeting upto conclusion of sixth AGM to be held in the year 2021 and thereafter can be re-appointed as auditor for one more term of five years i.e. upto year 2026. The appointment shall be subject to ratification by members at every annual general meeting of the company. As a result, the appointment of M/s Pear & Co. made by Apple Ltd. for 11 years is void. **(3 marks)**

c. **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".

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, RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of director, which is an 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.

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, 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.

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. **(1 mark)**

Title deeds of Immovable Property in the name of Director: As per Clause (i)(c) of Paragraph 3 of the CARO, 2016, the auditor is required to report on whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof.

The auditor should verify the title deeds available and reconcile the same with the fixed assets register. The scrutiny of the title deeds of the immovable property may reveal a number of discrepancies between the details in the fixed assets register and the details available in the title deeds. This may be due to various reasons which needs to be examined. **(1 mark)**

In the given case, NSP Limited has its factory building, appearing as fixed assets in its financial statements in the name of director. Thus, the auditor shall report on the same under Clause (i)(c) of Paragraph 3 of the CARO, 2016. **(1 mark)**

The reporting under this clause, where the title deeds of the immovable property are not held in the name of the Company, may be made incorporating following details, in the form of a table or otherwise:

A In case of land:-

- *total number of cases,*
- *whether leasehold / freehold,*

- *gross block and net block, (as at Balance Sheet date), and*
- *remarks, if any.*

B. In case of Buildings:-

- *total number of cases,*
- *gross block & net block, (as at Balance Sheet date) and*
- *remarks, if any.*

(1 mark)

Question 4

a. **SEBI's check list for auditors in respect of contract notes issued by a Stock Broker:**
   - Members should issue Contract Notes to his clients for all trades executed by him on their behalf.
   - The member should stamp his order sheets/records and the order time should be reflected in the Contract Note along with the time of execution of order.
   - The Contract Notes should bear SEBI Registration number of the member. It should be pre-printed with serial number and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.
   - The Contract Note should be signed by the member or his constituted attorney.
   - Contract note issued to the clients should show the brokerage separately.
   - In case the broker acts as a principal, the Contract Note should be in Form B.
   - Consent of the client should be taken for any trade done by the broker while acting as a principal.
   - Brokerage should be within the limits prescribed by the exchange.

(4 marks)

b. **Obligation of Auditor to Submit an Exception Report to the Bank**

i) Where, in the case of a non-banking financial company, the statement regarding any of the matters to be included in the auditor's report is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:
   - the provisions of Chapter III B of Reserve Bank of India Act, 1934; or
   - the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998; or
   - Non-Banking Financial (Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007; or
   - Non-Banking Financial (Non- Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

   it shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non -compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non -Banking Supervision of the Bank under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998. **(3 marks)**

ii) The duty of the Auditor under above stated paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions

referred to in sub-paragraph (I) and such report shall not contain any statement with respect to compliance of any of those provisions. **(1 mark)**

c. **Power of Central Government to direct special audit in certain cases:** As per the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

- that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual did and co-operative principles or prudent commercial practices or with sound business principles; or
- that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- that the financial position of any Multi-State co-operative society is such as to endanger its solvency. **(3 marks)**

The central Government may at any time by order direct that a special audit of the Multi-State co-operative society's accounts for such period or periods as may be specified in the order, shall be conducted and appoint either a chartered accountant or the Multi-State co-operative society's auditor himself to conduct the special audit. However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty- one percent or more of the paid-up share capital in such Multi-State co-operative society.**(1 mark)**

d. **Voting Power and Control over the composition of Board of Directors:** In this case, Alfa Ltd. holds only 10 percent of the voting power and control over the composition of the Board of Directors of Gamma Ltd. In such a case, Alfa Ltd. would be considered as a parent of Gamma Ltd. and, therefore, it would consolidate Gamma Ltd. in the consolidated financial statements as subsidiary.

The auditor should verify whether the parent controls the composition of the Board of Directors or corresponding governing body of any entity. There would be various means by which such kind of control can be obtained. **(1 mark)**

In this regard, the auditor may verify the Board's minutes, shareholder agreements entered into by the parent, agreements with the entities to which the parent might have provided any technology or know how, enforcement of statute, as the case may be, etc.

The auditor should verify that the adjustments warranted by the relevant accounting standards have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. The auditor should make plans, among other things, for the understanding of accounting policies of the parent, subsidiaries, associates and joint ventures and determining and programming the nature, timing, and extent of the audit procedures to be performed etc. **(1 mark)**

Further, the duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity are considered as Related Party. **(1 mark)**

In forming an opinion on the financial statements the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework and whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks) or cause the financial statements to be misleading (for compliance frameworks). **(1 mark)**

Question 5

a. **Scope and extent of investigation -** When a chartered accountant is appointed to carry out an investigation, the extent of enquiry, the objective of the investigation and the various matters referred to for investigation are specified in the order of investigation issued by the appointing authority. On a consideration thereof, the investigating accountant should determine the areas of accounts which require investigation and the extent to which the enquiry is to be made as well as his general approach to the enquiry. For example, if the allegation is that certain transactions have been entered into in contravention of the provisions of the Companies Act, the nature of transactions, the persons who were parties thereto, the amount or amounts involved and the circumstances under which these were entered into must be examined. If the loss suffered by the company has given rise to a gain by a director and other managerial personnel or its associates, the manner in which the benefit has accrued and the amount thereof shall have to be investigated.

(1 mark)

In case of a company having subsidiaries or where one or more directors are interested in one or more concerns, all the dealings with these concerns should be examined for these may have been entered into with the intention of transferring profit. Generally, all sales and purchases of goods and assets from directors and their associated concerns should be scrutinised since these also can be a vehicle of illicit transferring of profits. **(1 mark)**

Any breach of duty or abdication of responsibility for purposes of investigation would be material only if it has resulted in a loss to the company. In such a case, the factors responsible for the loss or losses, besides the amount thereof, shall have to be investigated. Negligence would be culpable only if it was in relation to a duty cast by the Act, Articles of Association or by a resolution of the shareholders or that of the Board of Directors. **(1 mark)**

Any negligence in the discharge of duty of a director or any other managerial personnel must be construed very broadly, for apart from being the agents of the company, they are trustees of its property. **(1 mark)**

It may be necessary for an investigator to interrogate directors, officers, agents, and others concerned with matters under his enquiry. Before drawing up his brief in this regard as well as for framing his conclusions, he should, if necessary, take legal assistance. If the Investigating accountant is required to report on the efficiency of the management, he should be discreet in expressing his opinion. Usually, it is sufficient if he merely indicates the general limitations of the management. The inspector must ensure that the persons who figure in the investigation get the fullest opportunity to explain their action and conduct. **(1 mark)**

b. **Differences between Financial and Operational Auditing:** The major differences between financial and operational auditing can be described as follows-

(i) **Purpose -** The financial auditing is basically concerned with the opinion that whether the historical information recorded is correct or not, whereas the operational auditing emphasizes on effectiveness and efficiency of operations for future performance.
(ii) **Area -** Financial audits are restricted to the matters directly affecting the appropriateness of the presented financial statements but the operational auditing covers all the activities that are related to efficiency and effectiveness of operations directed towards accomplishment of objectives of organization.
(iii) **Reporting -**The financial audit report is sent to all stock holders, bankers and other persons having stake in the Organisation. However, the operational audit report is primarily for the management.
(iv) End Task - The financial audit has reporting the findings to the persons getting the report as its end objective, however, the operational auditing is not limited to reporting only but includes suggestions for improvement also

(5 marks)

c. Factors to be considered while planning the Performance Audit: While planning a performance audit of an Industry, the auditors should take care of certain factors which are listed below:

a. to consider significance and the needs of potential users of the audit report.
b. to obtain an understanding of the program to be audited.
c. to consider legal and regulatory requirements.
d. to consider management controls.
e. to identify criteria needed to evaluate matters subject to audit.
f. to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.
g. to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.
h. to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.
i. to provide sufficient staff and other resources to do the audit.
j. to prepare a written audit plan.

(6 marks)

Question 6

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

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

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

This provision empowers the Council to enquire any misconduct of a member even if it does not arise of professional misconduct. **(2 marks)**

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

(i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
(ii) Where a chartered accountant makes a material misrepresentation.

(iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.
(iv) Conviction by a competent court of law for any offence under Section 8(v) of the Chartered Accountants Act 1949.
(v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.
(vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.
(vii) Where certain assessment records of income tax department belonging to the client of Chartered Accountant were found in the almirah of the bed-room of the chartered accountant.

(viii) Where a chartered accountant had adopted coercive methods on a bank for having a loan sanctioned to him.

(2 marks)

b. **Ceiling limit for signing the Tax Audit Reports**: As per Council General Guidelines 2008, a member of the Institute in practice shall not accept, in a financial year, more than the "specified number of tax audit assignments" under Section 44AB of the Income-tax Act, 1961. It is also provided further that where any partner of a firm of Chartered Accountants in practice accepts one or more tax audit assignments in his individual capacity, the total number of such assignments which may be accepted by him shall not exceed the "specified number of tax audit assignments" in the aggregate.

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

Further, as per clarification issued by the Institute on Tax Audit Assignments, tax audit reports may be signed by the partners in any manner whosoever in accordance with specified audit limits. Thus, one partner can individually sign all the tax audit reports subject to specified tax audit assignment limits on behalf of all the partners in the firm of Chartered Accountants in practice or all the partners of the firm can collectively sign the tax audit reports. **(2 marks)**

In the instant case, there are 6 partners in M/s XYZ & Co., a Chartered Accountants firm, accordingly specified ceiling limit for the firm will be (60 tax audit assignments per partner X 6 partners) = 360. Therefore, all the 6 partners of the firm can collectively sign 360 tax audit reports. This maximum limit of 360 tax audit assignments may be distributed

between the partners in any manner whatsoever. For instance, 1 partner can individually sign 360 tax audit reports in case remaining 5 partners are not signing any tax audit report.

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

Hence, Mr. Gaurav shall not be deemed to guilty of professional misconduct provided total number of tax audit reports on behalf of firm do not exceeds 360. **(2 marks)**

c. **Printing of QR Code on Visiting Cards: As per Clause (7) of Part I of First Schedule** to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he advertises his professional attainments or services. **(1 mark)**

Ethical Standards Board has also clarified that a member in practice is allowed to print Quick Response Code (QR Code) on the visiting Card, provided that the Code does not contain information that is not otherwise permissible to be printed on a visiting Card. **(1 mark)**

In the given case, Mr. M has printed visiting cards which carries Quick Response Code (QR Code) besides other details. The visiting card as well as the QR Code contains his name, office and residential address, contact details, e -mail id and name of the firm's website which are otherwise allowed to be printed on the visiting cards of a Chartered Accountant in practice.

Thus, Mr. M is not guilty under Clause (7) of Part I of First Schedule to the Chartered Accountants Act, 1949. **(2 marks)**

d. **Certification of Projected Financial Forecast**: **Under Clause (3) of Part I of Second Schedule** to the Chartered Accountants Act, 1949, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. **(1 mark)**

Further, SAE 3400 "The Examination of Prospective Financial Information", provides that the management is responsible for the preparation and presentation of the prospective financial information, including the identification and disclosure of the sources of information, the basis of forecasts and the underlying assumptions. The auditor may be asked to examine and report on the prospective financial information to enhance its credibility, whether it is intended for use by third parties or for internal purposes. Thus, while making report on projection, the auditor need to mention that his responsibility is to examine the evidence supporting the assumptions and other information in the prospective financial information, his responsibility does not include verification of the accuracy of the projections, therefore, he does not vouch for the accuracy of the same. **(1 mark)**

In the instant case, Mr. L, a chartered accountant, has **prepared** and certified a projected financial forecast of his client Abacus Ltd. which was forwarded to the client's bank to secure some loans and based on which the bank sanctioned a loan to the client is not in order.

Thus, Mr. L will be held guilty of misconduct in view of above. **(2 mark)**

Question 7

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

a. Audit Risk.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Three components of audit risk are:

i) Inherent risk (risk that material errors will occur);
ii) Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
iii) Detection risk (risk that any remaining material errors will not be detected by the auditor). **(2 ½ marks)**

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures. **(1/2 mark)**

Control risk - Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter

how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed. **(1/2 mark)**

Detection risk - For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. **(1/2 mark)**

b. Classification of frauds by NBFC:

In order to have uniformity in reporting, frauds have been classified as under -

- Misappropriation and criminal breach of trust.
- Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- Unauthorised credit facilities extended for reward or for illegal gratification.
- Negligence and cash shortages.
- Cheating and forgery.
- Irregularities in foreign exchange transactions.
- Any other type of fraud not coming under the specific heads as above.

(2 marks)

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

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

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

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

(2 marks)

c. Areas of Control for Reporting Stage of Peer Review.

The Peer Review Report should state that the system of quality control for the assurance services of the Practice Unit for the period under review has been designed so as to carry out the assurance services in a manner that ensures compliance with Technical, Professional and Ethical Standards.

The Peer Review Report shall address the compliance report or otherwise on the following areas of controls:

a. Independence.
b. Maintenance of Professional Skills and Standards.
c. Outside Consultation.
d. Staff Recruitment, Supervision and Development.
e. Office Administration **(2 marks)**

i) Discussion/Communication of Findings

After completing the on-site review, the Reviewer, before making his Report to the Board, shall communicate his findings to the Practice Unit if in his opinion, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification**.** The Practice Unit shall within 15 days after the date of receipt of the findings, make any submissions or representations, in writing to the Reviewer**. (1 mark)**

ii) Peer Review Report of Reviewer

At the end of an on-site review if the Reviewer is satisfied with the reply received from the Practice Unit, he shall submit a Peer Review Report to the Board along with his initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

In case the Reviewer is of the opinion that the response by the Practice Unit is not satisfactory, the Reviewer shall accordingly submit a modified Report to the Board incorporating his reasons for the same. The Reviewer shall also submit initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

In case of a modified report, The Board shall order for a "Follow On" Review after a period of one year from the date of issue of report as mentioned in (B) above. If the Board so decides, the period of one year may be reduced but shall not be less than six months from the date of issue of the report. **(1 mark)**

d. Register and Records generally prepared in respect of Claims by Insurance Companies.

The following register and records are generally prepared in respect of claims- **(4 marks)**

a. Claims Intimation Register;

b. Claims Paid Register;

c. Claims Disbursement Bank Book;

d. Claims Dockets, normally containing the following records:

Claim intimation, claim form, particulars of policy, survey report, Photograph showing damage, repairer's bills, letter of subrogation, police report, fire service report, claim settlement note, claim satisfaction note, salvage report, salvage disposal note, claims discharge voucher, etc.;

e. Report of quality assurance team; and

f. Salvage register.

The Claim Account is debited with all the payments including repair charges, fire fighting expenses, police report fees, survey fees, amount decreed by the Courts, travel expenses, photograph charges, etc. The provision for claims incurred but not reported is not made at Branch/Divisional Office level but at the Head Office level.

e. Relevant Criteria for determining Reliability of Data as per SA 520 'Analytical Procedures'

i. SA 520 on 'Analytical Procedures' provides that the reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. **(1 mark)**

ii. Accordingly, the following are relevant criteria when determining whether data is reliable for purposes of designing substantive analytical procedures- **(3 marks)**

1. Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
2. Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
3. Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
4. Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

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