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SUGGESTED SOLUTION

CA FINAL MAY'19

SUBJECT- AUDIT

Test Code - FNJ 7187

BRANCH - () (Date :)

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Answer 1: **(1 mark x 30 = 30 marks)**

1) D
2) D
3) C
4) C
5) C
6) C
7) A
8) B
9) A
10) A
11) A
12) C
13) B
14) A
15) A
16) A
17) A
18) A
19) B
20) A
21) C
22) B
23) D
24) B
25) C
26) C
27) A
28) A
29) A
30) C

Answer 2:

(A)

The firm should **obtain such information** as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. **Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.**

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.

- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The **extent of knowledge a firm will have regarding the integrity of a client** will generally grow within the context of an ongoing relationship with that client. **(5 marks)**

(B)

Projected Financial Statements : As per SAE 3400, "The Examination of Prospective Financial Information", the answer is divided into two parts i.e. (i) the things to be considered before accepting the engagement and (ii) audit evidence to be obtained for reporting on projected financial statements.

(i) **Acceptance of Engagement :** As per **SAE 3400, "The Examination of Prospective Financial Information"**, before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things :

(1) the intended use of the information;

(2) whether the information will be for general or limited distribution;

(3) the nature of the assumptions, that is, whether they are best – estimates or hypothetical assumptions;

(4) the elements to be included in the information; and

(5) the period covered by the information.

Further, the auditor should not accept, or should withdraw from, an engagement when the **assumptions are clearly unrealistic** or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

In accordance with **SA 210, "Terms of Audit Engagement"**, it is necessary that the auditor and the client should agree on the terms of the engagement. **(5 marks)**

Answer 3:
(A)

As per **SA 620**, Using the work of an Auditor's Expert, the **nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances**, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the **nature, timing and extent of communication between the auditor and the auditor's expert.** It is therefore required that these matters are agreed between the auditor and the auditor's expert.

In certain situations, the need for a detailed agreement in writing is required like -

- The auditor's expert will have access to sensitive or confidential entity information.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the

context of the audit.

In the given case, considering the **complexity involved in the valuation and volume of derivatives** and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement / engagement letter with the auditor's expert in respect of the work assigned to him. **(4 marks)**

(B)

Stepwise Approach of the Peer Reviewer : The stepwise approach which may be adopted by the reviewer is discussed below –

(i) The reviewer should **gain an understanding of the engagement letter** since an assurance engagement or for that matter any other kind of engagement should begin with an engagement letter. This understanding would help him in planning the review of documentation.

(ii) The number of assurance engagements to be selected requires the **exercise of judgement by the reviewer** based on the evaluation of replies given in the questionnaire and the size of the practice unit.

(iii) The practice unit may have policies and procedures for accepting a particular engagement. The reviewer should, wherever possible, examine that the **policies and procedures for acceptance of audit have been complied with and necessary documentation with regard to the same exists.**

(iv) The reviewer may follow a **combination of compliance procedures and substantive procedures** throughout the peer review process.

(v) Finally, the reviewer while evaluating records may consider the following :

→ Determine that any significant issues, matters, problems that arose during the course of the engagement have been appropriately considered, resolved and documented;

→ Determine that adequate audit evidence or other relevant evidence in relation to the engagement is obtained to support the reasonableness of the conclusions drawn; and

→ Determine that significant decisions relating to the engagement, use of professional judgement, resolution of significant matters have been properly documented.

(5 marks)

(C)

Emphasis of Matters Para :

- We draw attention to Note XX, regarding certain income – tax demands of Rs. 100 crores pending in various stages of assessments/ appeals. The management based upon expert's advice believes that no demand or liability including interest and penalty on account of settlement of assessment/ appeals of the pending matters by the Income tax authorities is likely to devolve on the Company, in addition to those already provided for in these financial statements. Pending the final outcome of the aforesaid matters, no further adjustments have been made in these financial statements in this regard.

- Note XX of the financial statements that as at March 31, 2017, the Company has accumulated losses of Rs. 150 crores against equity of Rs. 100 crores and also net current liabilities of Rs. 35 crores. These conditions indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern, which is dependent on establishing profitable operations and obtaining continuing financial support from its key shareholders. These mitigating factors have been more fully discussed in Note XX of the accompanying financial statements, in view of which the accompanying financial statements have been prepared under the going concern assumption, and consequently, no further adjustments have been made in these financial statements.
  Our opinion is not modified in respect of the above matters. **(6 marks)**

(D)

Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. **<u>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</u>** that **<u>allocate a larger portion of audit resources to high-risk areas.</u>**

RBA consists of **<u>four main phases</u>** starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:

Step 1 - Understand auditee operations to identify and prioritize risks:
Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

Step 2 - Assess auditee management strategies and controls to determine residual audit risk: Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.

Step 3 - Manage residual risk to reduce it to acceptable level: Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.

Step 4 - Inform auditee of audit results through appropriate report: The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data. **(5 marks)**

Answer 4:
(A)

Stage 1- Pre-audit or Planning Stage:

Audit planning is vital to the success of the audit undertaken. During this stage of audit, generally following steps are taken:

Collect background information about the entity

(ii) Define objectives of audit

(iii) Define scope –

(iv) Choose audit criteria

(v) Select the audit team members

(vi) Develop audit plan and protocols

(vii) Inform the facility

(viii) Desktop review.

Stage 2 - On-site or Field Audit

The following are steps involved in on-site or field audit:

(i) Opening conference.

(ii) Facility tour

(iii) Site/ facility inspection

(iv) Evidence

(v) Records/ document review

(vi) Staff interviews

(vii) Initial review of findings

(viii) Closing/ exit conference.

(ix)

Stage 3- Post – Audit

Steps involved in post – audit are as follows:

(i) Final evaluation of findings

(ii) Draft preliminary audit report

(iii) Get approval of the management

(iv) Hold exit conference

(v) Discuss recommendations, if any

(vi) Prepare and submit final report.

Stage 4.: Follow up or Review Stage :

This is also called corrective action follow-up phase. While not technically part of the audit, the audit manager or team leader may be involved in developing a corrective action plan for addressing audit findings with the facility and reporting to senior management as to the progress of this plan. **(4 marks)**

(B)

Charging of Fees based on Percentage: **<u>Clause (10) of Part I to First Schedule</u>** to the Chartered Accountants Act, 1949 prohibits a Chartered Accountant in practice to charge, to offer, to accept or accept fees which are based on a percentage of profits or which are contingent upon the findings or results of such work done by him.

However, this **<u>restriction is not applicable where such payment is permitted by the Chartered Accountants Act, 1949.</u>** The Council of the Institute has framed Regulation 192 which exempts debt recovery services where fees may be based on a percentage of the debt recovered.

In the given case, CA. Neha has charged fees based on percentage of the debt recovered (which is exempted under Regulation 192). Hence, CA. Neha will not be held guilty for professional misconduct. **(4 marks)**

(C)

<u>SA 500 on "Audit Evidence"</u> discusses the auditor's responsibility in relation to and the procedures the auditor should consider in, using the work of an expert as audit evidence. During the audit, the **<u>auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert,</u>** e.g., legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc. Before relying on advocate's opinion, the auditor should have seen that opinion given by the management's expert is *prima facie* dependable. The question states very clearly that the opinion of the advocate was inconsistent with legal position with regard to certain items. It is, perhaps, quite possible that auditor did not seek reasonable assurance as to the appropriateness of the source data, assumptions and methods used by the expert properly.

In fact, **<u>SA 500</u>** makes it incumbent upon the part of the **<u>auditor to resolve the inconsistency by discussion with the management and the expert</u>**. In case, the expert's' work does not support the related representation in the financial information the inconsistency in legal opinions could have been detected by the auditor if he had gone through the same. This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the auditor should have rejected the opinion and insisted upon making proper provision. **(6 marks)**

(D)

(Students can write any six points)

Special points that may be covered in the audit of NBFCs in case of Investment Compaines are given below :

(i) **<u>Physically verify all the shares and securities</u>** held by a NBFC, Where any security is lodged with an institution or a bank, a certificate from the bank / institution to that effect must be verified.

(ii) **NBFC Prudential Norms** stipulates that NBFCs should not lend more than 15% of its owned funds to any single borrower and not more than 25% to any single group of borrower. The ceiling on investments in shares by a NBFC in a single entity and the aggregate of investments in a single group of entities has been fixed at 15% and 25% respectively. Moreover, a composite limit of credit to and investments in a single entity/ group of entities has been fixed at 25% and 40% respectively of the owned fund of the concerned NBFC. Verify that the credit facilities extended and investments made by the concerned NBFC are in accordance with the prescribed ceiling.

(iii) Verify whether the NBFC has **not advanced any loans against the security of its own shares.**

(iv) Verify that **dividend income** whether declared by a company, has been duly received by a NBFC and interest wherever due [except in case of NPAs] has been duly accounted for.

(v) Test check **bills/ contract notes received from brokers** with reference to the prices vis – a – vis the stock market quotations on the respective dates.

(vi) Verify the **board Minutes for purchase and sale of investments**. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.

(vii) Check whether the investments have been **valued in accordance with the NBFC Prudential Norms,** Directions and **adequate provision** for all in the market value of securities, wherever applicable, have been made there against, as required by the Directions.

(viii) Obtain a list of **subsidiary / group companies** from the management and verify the investments made in subsidiary / group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.

(ix) Check whether investments in **unquoted debentures/ bonds** have not been treated as investments but as **term loans** or other credit facilities for the purposes of income recognition and asset classification.

(x) An auditor will have to ascertain whether the requirements of **AS 13 "Accounting for Investments"** (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

(xi) In respect of shares/ securities held through a depository, obtain a **confirmation from the depository** regarding the shares/ securities held by it on behalf of the NBFC.

(xii) In the case of securities lent/ borrowed under the **Securities Lending Scheme** of SEBI, verify the agreement entered into with the **approved intermediary** (i.e. the person through whom the lender will deposit and the borrower will borrow the securities for lending / borrowing) with regards to the period of depositing/ lending securities, fees for depositing/ lending, collateral securities and provision for the return including premature return of the securities deposited / lent.

(xiii) Verify that securities of the same type or class are received back by the lender/ paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).

(xiv) Verify **charges received or paid** in respect of securities lent/ borrowed.

(xv) Obtain a **confirmation from the approved intermediary** regarding securities deposited with/ borrowed from it as at the year end. **(1 mark x 6 = 6 marks)**

Answer 5:

(A)

Printing of QR Code on Visiting Cards: **<u>As per Clause (7) of Part I of First Schedule</u>** 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.

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

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. **(4 marks)**

(B)

Issuing Certificate without having Certificate of Practice: As per **<u>Clause (1) of Part II of Second Schedule</u>** to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council.

<u>This clause requires every member of the Institute to act within the framework</u> of the Chartered Accountants Act and the Regulations made thereunder. **<u>Any violation either of the Act or the Regulations by a member would amount to misconduct.</u>**

In the given case, CA. Vineet has issued a certificate in respect of a consumption statement of raw material to the manager of ZedEx (P) Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA. Vineet will be held guilty of professional misconduct in terms of Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act. **(4 marks)**

(C)

Audit Procedures - In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following :

(a) Evaluation of Internal Controls over Advances :

- Examine loan documentation;
- Examine the validity of the recorded amounts;
- Examine the existence, enforceability and valuation of the security;
- Ensure compliance with the terms of sanction and end use of funds.
- Ensure compliance with Loan Policy of Bank as well as RBI norms including appropriate classification and provisioning
- Review the operation of the accounts;

(b) Substantive Audit Procedures

- Check that amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- Check that advances represent amount due to the bank.
- Verify that amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- Ensure there are no unrecorded advances.
- Check that the stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- Verify that the advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements.
- Check that appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
- Examine all large advances while other advances may be examined on a sample basis.
- Verify completeness and accuracy of interest being charged.

(c) Recoverability of Advances:

- Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
- Review latest financial statements of borrowers.
- Review reports on inspection of security.
- Review Auditor's reports in the case of borrowers enjoying aggregate credit limits of Rupees 10 lakh or above for working capital from the banking system. **(6 marks)**

(D)

<u>The Internal Control structure in an organization is referred to as the policies and procedures established by the entity to provide reasonable assurance that the objectives are achieved.</u> The control structure in an organization basically has the following components:

1. **Control Environment -** Control environment covers the effect of various factors like management attitude; awareness and actions for establishing, enhancing or mitigating the effectiveness of specific policies and procedures.
2. **Accounting System -** Accounting system means the series of task and records of an entity by which transactions are processed for maintaining financial records. Such system identifies, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.
3. **Control Procedure -** Policies and procedures means those policies and procedures in addition to the control environment and accounting systems which the management has established to achieve the entity's specific objectives.

   In this regard, the management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent that they are appropriate to the size and nature of the business. There should be reasonable assurance for the auditor that the accounting system is adequate and that all the accounting information required to be recorded has in fact been recorded.

Internal controls normally contribute to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, he could reduce his substantive procedures which otherwise may be required and may also differ as to the nature and timing.

Specific Requirement under **SA 315 - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"** deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control. **(6 marks)**

Answer 6:

(A)

(a) Since the **goods were not approved and returned after the stipulated period of 6 months, the value of the said supplies would not be included in turnover in the audited financial statements**. However, as per the 2nd proviso to Section 142(12) of the CGST Act since the goods were returned after 6 months from appointed date (i.e. 1.6.2017), GST would be payable for the tax period December 2017. Though the transaction originated in the period April 2017 to June 2017, the turnover will not be reflected under this Sl.No. However, one may reflect such adjustment under Part II, sl. No. 5 Clause O – 'Adjustments in turnover due to reasons not listed above' as addition.

(b) **The said goods are liable to excise duty since the goods have been cleared on 30.4.2017. The goods would not form part of turnover as per the financial statements since it is a branch transfer**. It would stand reflected as branch transfers under the State Level VAT laws. Since audit is being conducted for Bangalore GSTIN and since supply has occurred from Hyderabad GSTIN, it would not be necessary to make adjustments for the period April 2017 to June 2017.

(c) As per proviso to Rule 3(b) of the Clause of Taxation Rules, 2011, **the point of taxation in the impugned case would be the date on which bill has been raised i.e. 3.7.2017**. Though invoice has been raised in the GST regime, service tax is payable since service has been provided during the currency of the Finance Act, 1994. The date for payment of service tax as per the machinery provision i.e. POTR, 2011 may be 3.7.2017 but the said service would be liable to service tax because the charge u/s 66B gets attracted for the period June 2017. Further as per S.142(11)(b) since if a transaction is *liable* for service tax, then tax would not be payable under the GST Laws. Hence the said amount should be deducted as turnover under this Sl. No. for the period April 2017 to June 2017. **(2 marks x 3 = 6 marks)**

(B)

The main features of a qualified and independent audit committee to be set up under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 are as follows:

1. The audit committee shall have minimum three directors as members. Two- thirds of the members of audit committee shall be independent directors;
2. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise;

   Explanation (i): The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

   Explanation (ii): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.
3. The Chairperson of the Audit Committee shall be an independent director;
4. The Chairperson of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;
5. The Audit Committee at its discretion shall invite the finance director or the head of the finance function, head of internal audit and a representative of the statutory auditor and any other such executives to be present at the meetings of the committee; provided that occasionally, the Audit Committee may meet without the presence of any executives of the listed entity.;
6. The Company Secretary shall act as the secretary to the committee.

(5 marks)

(C)

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 guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit Rs. 50,000 as earnest deposit and shall not have committed any professional misconduct.

(4 marks)

(D)

Sr. No.	Particulars	Other Audits	Forensic Audit
1.	Objectives	Express an opinion as to 'True & Fair presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations
4.	Verification of stock, Estimation realisable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

(5 marks)