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**CA FINAL**

**SUBJECT- AUDIT**

**Test Code – FNJ 7418**

**BRANCH - () (Date :)**

**Head Office : Shraddha, 3<sup>rd</sup> Floor, Near Chinai College, Andheri (E), Mumbai – 69.**

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**DIVISION A – MCQS (30 MARKS)**

**Case Scenario :1**

1. C
2. B
3. C
4. B
5. C

**(5 × 2 = 10 Marks)**

**Case Scenario :2**

1. A
2. D
3. C
4. B
5. D

**(5 × 2 = 10 Marks)**

**GENERAL MCQs**

1. C
2. D
3. D
4. C
5. B
6. A
7. D
8. C
9. D
10. B

**(10 × 1 = 10 Marks)**

**SECTION : B – DESCRIPTIVE QUESTIONS (70 Marks)**

**ANSWER : 1(A)**

(i) As per clause (xiii) of para 3 of CARO 2016 the auditor is required to report, “whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards”.

In the present case, the auditor is required to report as per clause xiii of para 3 of CARO 2016 receipt of long term borrowing from Parent Company which is transactions with the related party.

(ii) As per clause Clause (x) of para 3 of CARO 2016 the auditor is required to report, “whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.”

In the instant case, a fraud has been identified in recruitment of employees by the HR Department wherein certain sums were alleged to have been taken as kickback from the company of amounting rupees approx. 12 lakh. The auditor is required to report on the same in accordance with clause (x) of para 3 of CARO 2016.

**(5 marks)**

**ANSWER : 1(B)**

**Reporting for Default in Repayment of Dues :** As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, terms of repayment of term loans and other loans is required to be disclosed in the notes to accounts. It also requires specifying the period and amount of continuing default as on the balance sheet date in repayment of loans and interest, separately in each case.

Further, as per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to state in his report whether the Company has defaulted in repayment of dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

In the given case, C Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2016 – 17 which remain outstanding as at March 31, 2017. However, the company has settled the total outstanding dues including interest in April, 2017 but, the dues were outstanding as at March 31, 2017. Therefore, it needs to be reported in the notes to accounts.

**The draft report for above matter is as under :**

“The company has taken a loan during the year, from a financial institution amounting to Rs. XXXX @ X% p.a. which is repayable by monthly instalment of Rs. XXXX for XX months.

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2015 – 16 amounting to Rs. XXXX which remained outstanding as at March 31, 2017. The period of default is XXX days. However, the outstanding sum was settled by the company in April, 2017.”

**(5 marks)**

**ANSWER : 1(C)**

As per SA 220, the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. For audits of financial statements of listed entities, the engagement partner shall:

- Determine that an engagement quality control reviewer has been appointed;
- Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- Not date the auditor's report until the completion of the engagement quality control review.

SA 700 also requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements. In cases of an audit of financial statements of listed entities where the engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

In the given case, the signing of auditors' report before completion of review of engagement quality control review is not right.

**(4 Marks)**

**ANSWER : 2(A)**

**Closure of Business :** As per SA 570 "Going Concern", management intentions to liquidate the entity or to cease operations is one of the event or condition that may cast significant doubt on the entity's ability to continue as going concern.

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

Even when no material uncertainty exists, it requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

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

As per the facts given in the case, intention of the Toddle Limited had definite plan of its business being closed down within short period from 31 March, 2017. However, financial statements for the

year ended 31.3.2017 had been prepared on the same basis as it had been in earlier periods with an additional note.

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

**(5 Marks)**

**ANSWER : 2(B)**

**Consolidated Financial Statements :** According to Section 129(3) of the Companies Act, 2013 where a company has one or more subsidiaries including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.

Further, as per Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

However, an investment entity need not present consolidated financial statements if it is required, in accordance with Ind AS 110 'Consolidated Financial Statements', to measure all of its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

(An investment entity is an entity that (a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.)

In the given case, H Limited is an investment company preparing its financial statements in accordance with Ind AS and the company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the investee companies. In view of provisions discussed in Ind AS 110, the Company is not required to prepare consolidated financial statements however, for the compliance of Companies (Accounts) Rules, 2014, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

Thus, it can be concluded that ultimate authority on consolidation is AS / Ind AS as prescribed by law and if they give some exemption it should be followed. If out of exemption some subsidiaries are not consolidated, then list should be disclosed in notes to accounts with reason.

**(5 Marks)**

**ANSWER : 2(C)**

**Sharing and Accepting of Part of Profits with an Advocate:** According to Clause (2) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he pays or allows or agrees to pay or allow,

directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute, for the purpose of rendering such professional services from time to time in or outside India.

Furthermore, Clause (3) of Part I of the First Schedule to the said Act states that a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he accepts any part of the profits of the professional work of a person who is not a member of the Institute.

However, a practicing member of the Institute can share fees or profits arising out of his professional business with such members of other professional bodies or with such other persons having such qualifications as prescribed by the Council under Regulation 53 – A of the Chartered Accountants Regulations, 1988. Under the said regulation, the member of “Bar Council of India” is included.

Therefore, Mr. Preet, an advocate, a member of Bar Council, is allowed to share part of profits of his professional work with Ms. Preeti. Hence, Ms. Preeti, a practicing Chartered Accountant, will not be held guilty under any of the abovementioned clauses for paying and accepting part of profits from Mr. Preet.

**(4 Marks)**

**ANSWER : 3(A)**

**Audit Procedure:** The auditor should, *inter alia*, do the following for verification of commission:

- Ensure that commission/brokerage is not paid in excess of the limits specified by IRDAI
- Ensure that commission/brokerage is paid as per rates with the agent and rates filed with IRDAI
- Ensure that commission/brokerage is paid to the agent/broker who has solicited the business
- Ensure that the agent/broker is not blacklisted by IRDAI and is not terminated for fraud etc.
- Vouch disbursement entries with reference to the disbursement vouchers with copies of commission bills and commission statements.
- Check whether the vouchers are authorised by the officers-in-charge as per rules in force and income tax is deducted at source, as applicable.
- Test check correctness of amounts of commission allowed.
- Scrutinise agents’ ledger and the balances, examine accounts having debit balances, if any, and obtain information on the same. Necessary rectification of accounts and other remedial actions have to be considered.
- Check whether commission outgo for the period under audit been duly accounted.

**(5 Marks)**

**ANSWER : 3(B)**

**Using the work of an Auditor’s Expert :** As per SA 620 “Using the Work of an Auditor’s Expert”, the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans etc., however, the auditor has sole responsibility for

the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. X, Mr. Y and Mr. Z, jointly appointed as an auditor of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor's expert as per SA 620. Mr. Y's referred actuary has provided the gratuity valuation report, which later on found faulty. Further, Mr. Z is not agreed with this report therefore the submitted a separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. X, Mr. Y and Mr. Z, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. X and Mr. Y will be held responsible for grossly negligence and using such faulty report without examining the adequacy of expert actuary's work whereas Mr. Z will not be held liable for the same due to separate opinion expressed by him.

**(5 Marks)**

**ANSWER : 3(C)**

**Areas excluded from scope of Peer Reviewer are:**

- (i) Management Consultancy Engagements;
- (ii) Representation before various Authorities;
- (iii) Engagements to prepare tax returns or advising clients in taxation matters;
- (iv) Engagements for the compilation of financial statements;
- (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
- (vi) Testifying as an expert witness;
- (vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and
- (viii) Engagement for Due diligence.

**(4 Marks)**

**ANSWER : 4 (A)**

Audit should be risk – based or focused on areas of greatest risk to the achievement of the audited entity’s objectives. Risk – based audit (RBA) is an approach to audit that analyses audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high – risk areas.

RBA consists of four main phases 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 organisation’s ability to record, process, summarize and report financial data.

**(5 Marks)**

**ANSWER : 4 (B)**

Over-Valued Assets: In case of due diligence exercise, the area of analysis in order to ensure that the assets are not stated at over-valued amounts are:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.

- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances not reconciled.
- Intangibles having no reliable value.

(5 Marks)

**ANSWER : 4 (C)**

**Reporting under CARO, 2016 for Registration under RBI Act, 1934 :** As per **Clause (xvi) of paragraph 3 of the CARO, 2016**, the auditor is required to report whether the company is required to be registered under **section 45 – IA of the Reserve Bank of India Act, 1934**. If so, whether the registration has been obtained.

**Audit Procedure and Reporting –**

- The auditor should examine the **transactions of the company** with relation to the activities covered **under the RBI Act** and directions related to the Non – Banking Financial Companies.
- The financial statements should be examined to ascertain whether company's **financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income**.
- Whether the company has **net owned funds** as required for the registration as NBFC.
- Whether the company has obtained the **registration as NBFC**, if not, the reasons should be sought from the management and documented.

(4 Marks)

**ANSWER : 5 (A)**

**Ceiling on Number of Audit:** As per section 141(3)(g) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor if he is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 crore private company (which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar).

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be  $3 \times 20 = 60$  company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

In the given case, CA Mukti is holding appointment in 4 companies, whereas CA Shakti is having appointment in 6 Companies and CA Yukti is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

- Therefore, MSY & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm	= $20 \times 3 =$	60
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Number of Audits already taken by all the partners in their individual capacity	= 4+6+10 =	<u>20</u>
Remaining number of Audits available to the Firm	=	<u>40</u>

- (ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g) - already holding appointments as an auditor. Hence (1) CA Mukti can hold:  $20 - 4 = 16$  more audits. (2) CA Shakti can hold  $20-6 = 14$  more audits and
- (1) CA Yukti can hold  $20-10 = 10$  more audits.
- (iii) In view of above discussed provisions MSY & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than Rs. 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar), 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.
- (iv) As per fact of the case, MSY & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition, they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than rupees 100 crores (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar). In the given case, out of the 60 private companies, MSY & Co. is offered 45 companies having paid-up share capital of Rs. 110 crore each.

Therefore, MSY & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than Rs. 100 crore (private company which has not committed a default in filing its financial statements under section 137 of the said Act or annual return under section 92 of the said Act with the Registrar.”.) and 40 private companies having paid-up share capital of Rs. 110 crore each in addition to above 20 company audits already holding.

**(5 Marks)**

**ANSWER : 5 (B)**

**Grossly Negligent in Conduct of Duties:** As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor’s duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management’s representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Accordingly, Mr. Anil, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

**(5 Marks)**

**ANSWER : 5 (C)**

**C&AG's Role** – The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognised as a 'friend, philosopher and guide' of the Committees.

- (i) His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports;
- (ii) He scrutinises the notes which the Ministries submit to the Committees and helps the Committees to check the correctness of submissions to the Committees and facts and figures in their draft reports;
- (iii) The Financial Committees present their Report to the Parliament/ State Legislature with their observations and recommendations.

The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature ;

- (iv) In respect of those Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature.

This ensures that the Audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

**(4 Marks)**

**ANSWER : 6(A)**

There are differences in Audit by Tax Authorities and the Special Audit. Such differences can be analysed as under –

- (1) The audit by tax authorities is conducted by the revenue officers whereas special audit is conducted by the CA/ Cost Accountants on the penal of the department.
- (2) The audit by tax authorities is conducted by the revenue officers either the tax payer's office or at their own office whereas special audit is conducted by the CA/ Cost Accountants at the taxpayer's office.
- (3) The audit by tax authorities can be invoked in a routine manner by the revenue officers whereas special audit is invoked with the prior approval of the Commissioner if the nature of business of the auditee is found to be complex.
- (4) The audit by tax authorities is to be completed within 3 months which is further extendable by another 6 months, whereas special audit is to be completed within 90 days which is further extendable by another 90 days.

**(5 Marks)**

**ANSWER : 6(B)**

**Real Time Environment** : IT Components : To facilitate transactions in real – time, it is essential to have the systems, networks and applications available during all times. A real – time environment

has several critical IT components that enable anytime, anywhere transactions to take place. Any failure even in one component could render the real – time system unavailable and could result in a loss of revenue. IT Components include :

- (i) Applications : For example, ERP applications SAP, Oracle E – Business Suite, Core banking applications.
- (ii) Middleware : For example, Webservers like Apache, Oracle Fusion, IIS.
- (iii) Networks : For example, Wide Area Networks, Local Area Network.
- (iv) Hardware : For example, Servers, Backup and Storage devices.

**(5 Marks)**

**ANSWER : 6(C)**

**Operational audit**, (functional audit) as it is the audit for the management and involves verifying the effectiveness, efficiency and economy of operations done by the Simony travels for the organisation.

The operational auditor should possess some very essential personal qualities to be effective in his work :

1. In areas beyond accounting and finance, his knowledge ordinarily would be rather scanty and this is a reason which should make him even more inquisitive.
2. He should ask the who, why, how of everything. He should try to visualise whether simpler alternative means are available to do a particular work.
3. He should try to see everything as to whether that properly fits in the business frame and organisational policy. He should be persistent and should possess an attitude of scepticism.
4. He should not give up or feel satisfied easily. He should imbibe a constructive approach rather than a fault – finding approach and should give a feeling that his efforts are to help attaining an improved operation and not merely fault finding.
5. If the auditor succeeds in giving a feeling of help and assistance through constructive criticism, he will be able to obtain co – operation of the person who are involved in the operations. This will itself be a tremendous achievement of the operational auditor. He should try to develop a team comprised of people of different backgrounds. Involvement of technical people in operational auditing is generally helpful.

**(5 Marks)**