(ALL BATCHES)

DATE: 18.08.2018 **MAXIMUM MARKS: 100** **TIMING: 3¼ Hours**

PAPER 6 : AUDITING

Answer to questions are to be given only in English except in the case of candidates who have opted for Hindi Medium. If a candidate who has not opted for Hindi Medium. His/her answer in Hindi will not be valued.
Question No. 1 is compulsory.
Candidates are also required to answer any Four questions from the remaining Five Questions.
In case, any candidate answers extra question(s)/sub-question(s) over and above the required number, then only the requisite number of questions first answered in the answer book shall be valued and subsequent extra question(s) answered shall be ignored.
Wherever necessary, suitable assumptions may be made and disclosed by way of note.

Answer 1:

(1 Mark each for Correct/Incorrect and 1 Mark for reason)

(a) Incorrect: As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements. However, the auditor shall express qualified opinion when he concludes that misstatement, individually or in aggregate are material but not pervasive.

(b) Correct: As per SA 299 "Responsibility of Joint Auditors", if a joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

(c) Incorrect: As per section 143(12) of the Companies Act, 2013 read with the Companies (Audit and Auditors) Rules, 2014, if an offence of fraud, which involves amount of rupees 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Board or the Audit Committee immediately or within 2 days of his knowledge of the fraud seeking their reply or observations within 45 days and forward the report to the Central Government within 15 days from the date of receipt of such reply or observations. However, in case of a fraud, which involves amount of less than rupees 1 crore, the auditor shall report the matter to the Board or the Audit Committee.

(d) Correct: An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

(e) Incorrect: Any casual vacancy in the office of a Cost Auditor, whether due to resignation, death or removal, shall be filled by the Board of Directors within 30 days of occurrence of such vacancy and the company shall inform the central government in Form CRA-2 within 30 days of such appointment of cost auditor.

(f) Incorrect: Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed 5% of its average net profits for the three immediately preceding financial years.

(g) Incorrect: Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching is not merely to ascertain that money has been paid away; but the auditor aims to obtain reasonable assurance in respect of assertions in regard to transactions recorded in the books of account.

(h) Incorrect: An engagement letter may need to be entered into for each year of the period covered by the eligibility letter issued by the auditor under Section 139 of the companies act 2013 and the appointment letter received from the company, to supplement – update for any subsequent changes. This may be required because the appointment would need to be ratified at each AGM under section 139 of the said Act.

(i) Incorrect: There is an inverse relationship between detection risks and the combined level of inherent and control risks. When inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. When inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risks to an acceptably low level.

(j) Incorrect: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

Answer 2:

(a) Assertions used by the auditor to consider the different types of potential misstatements that may occur with respect to classes of transactions and events for the period under audit:

(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

(ii) Completeness—all transactions and events that should have been recorded have been recorded.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cut-off—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

(1 Mark for each point)

(b) {Under sub-section (3) of section 141 **(¼M)** along with Rule 10 of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following person shall not be eligible for appointment as an auditor of a company, namely-

any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Section 144 of the Companies Act, 2013 is a new provision which prescribes certain services not to be rendered by the auditor.} {An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services}**(¼M)** {(whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company)} **(¼M)**, namely:

(i) accounting and book keeping services;
(ii) internal audit;
(iii) design and implementation of any financial information system;
(iv) actuarial services;
(v) investment advisory services;
(vi) investment banking services;
(vii) rendering of outsourced financial services;
(viii) management services; and
(ix) {any other kind of services as may be prescribed.} **(¼M)**

(½ Mark for each point)

(c) Auditing the Receipts from Patients of a Hospital: Following are the steps to be considered -

(i) Examine the internal check system as regards the receipts of bills from the patients.
(ii) Vouch the register of patients with copy of bills issued to them.
(iii) Verify bills for a selected period with the patient's attendance record to see that the bills have been correctly prepared.
(iv) See that bills have been issued to all the patients according to the rules of the hospital.
(v) Check cash collections as entered in the cash book with the receipts, counterfoils and other evidence.
(vi) Compare the total income with the amount budgeted for the same and report to the management for significant variations which have been taken place.

(1 Mark for each point) (Max. 5M)

(d) Decrease in Rate of Gross Profit on Sales: When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause **decrease in the gross profit** of the manufacturing company-

(i) Undervaluation of closing inventory or overvaluation of opening inventory either due to wrong valuation of inventory or mistake in inventory taking.
(ii) Change in the basis of inventory valuation. For example, opening inventory was valued at market price above cost when closing inventory valued at cost which is below the market price.
(iii) Inclusion in the current year, the amount of goods purchased in the previous year that were received and taken in the same year.
(iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.
(v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.
(vi) Excess provisions for wages or direct expenses have been made.
(vii) Goods sent out for sale on approval or on a consignment basis not included in closing inventory.
(viii) Value of unusual inventory of consumable stores (fuel and packing materials) are not shown as inventory or not adjusted from corresponding expenses.
(ix) Expenses which should be charged in the Profit and Loss Account but wrongly charged to the Trading Account.
(x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.
(xi) Goods sold or given as samples or destroyed, not accounted for.

(½ Mark each for any one valid/correct point) (Max. 5M)

Answer 3:

(a) Knowledge of the Client's Business: It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment" the auditor shall obtain an understanding of the following:

(i) {Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.} **(1M)**

(ii) {The nature of the entity}**(½M)**, including:

1. its operations;
2. its ownership and governance structures;
3. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
4. the way that the entity is structured and how it is financed;

(¼ Mark for each point)

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) {The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.} **(1M)**

(iv) {The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.) **(1M)**

(v) {The measurement and review of the entity's financial performance} **(½M)**.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgements regarding the appropriateness of accounting policies and disclosures.

(b) {Detection of Fraud and Error - Duty of an Auditor: As per SA-240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management} **(½M)**. Broadly, the general principles laid down in this regard are:

(i) An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs. **1M**

(ii) The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. **1M**

(iii) Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. **1M**

(iv) When obtaining reasonable assurance, the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement. **1M**

It may be concluded from the above that detection of fraud and error is not the duty of the auditor provided that he complies with the requirements given in Standards on Auditing, maintains professional scepticism throughout the audit and is not grossly negligent in the performance of his duties as an auditor. **½M**

(c) Factors which influence auditor's judgement: The various factors which may influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under:

(1 Mark for any 5 point)

(i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.
(ii) The materiality of the item.
(iii) The experience gained during previous audits.
(iv) The results of auditing procedures, including fraud and errors which may have been found.
(v) The type of information available.
(vi) The trend indicated by accounting ratios and analysis.

(d) Special resolution for entering into transaction(s) with any related party: Prior approval of the company by a special resolution is required for entering into transaction(s) with any related party, where transaction(s) to be entered into:-

1. are contracts or arrangements, with criteria as mentioned below-

(½ Mark for each point)

(i) sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding 10% of the turnover of the company or Rs. 100 crore, whichever is lower;
(ii) selling or otherwise disposing of or buying property of any kind, directly or through appointment of agents, exceeding 10% of net worth of the company or Rs. 100 crore, whichever is lower;
(iii) leasing of property of any kind exceeding 10% of the net worth of the company or 10% of turnover of the company or Rs. 100 crore, whichever is lower;
(iv) availing or rendering of any services directly or through appointment of agents exceeding 10% of the turnover of the company or Rs. 50 crore, whichever is lower;

It may be noted that the limits specified above shall apply for transaction(s) to be entered into either individually or taken together with the previous transactions during a financial year. **1M**

2. is for appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding Rs. 2.5 lakh; **1M**
3. is for remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding 1% of the net worth. **1M**

Answer 4:

(a) Propriety Audits: The Propriety audit is to vet the expenditure in the annals of financial wisdom and uprightness. It is to check to bring out the improper, avoidable, or infructuous expenditure even though such expenditure has been incurred in conformity with the existing rules and regulations. A transaction may satisfy all the requirements of regularity audit in so far as the various formalities regarding rules and regulations are concerned but may still be highly wasteful. It is not audit of sanction or against norms. It is a qualitative, opinion-based expression of auditor's findings as regards the efficiency, effectiveness and economy dimensions of expenditure. **1M**

In this regards, the following main points should be kept for consideration:

(1) The expenditure should not be prima facie more than what the occasion demands. Public money should be spent by the officers as of his own with utmost diligence and care. **½M**

(2) No order for sanction of expenditure should be made by an authority which results in pecuniary gains directly or indirectly. **½M**

(3) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
- (i) the amount of expenditure involved is insignificant; or
- (ii) a claim for the amount could be enforced in a Court of law; or
- (iii) the expenditure is in pursuance of a recognised policy or custom; and
- (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

1M

(4) There should not be profiteering by the authority or anybody where the expenditure is in the nature of compensating.

(5) Wastages are avoided in expenditure. The cost of administering should not eat off the benefits of the expenditure.

(6) The expenditure should percolate down the beneficiary without corruption.

(7) The expenditure should bring out optimum, enduring benefits instead of mere frittering away the public money on meeting day to day needs repeatedly.

(½ Mark for each point)

(b) The Narrative Record: {This is a complete and exhaustive description of the system as found in operation by the auditor} **(1M)**. {Actual testing and observation are necessary before such a record can be developed} **(1M)**. {It may be recommended in cases <u>where no formal control system is in operation</u> **(¾M)** and <u>would be more suited to small business</u> **(¾M)**}. The basic disadvantages of narrative records are:

(i) To comprehend the system in operation is quite difficult.
(ii) To identify weaknesses or gaps in the system.
(iii) To incorporate changes arising on account of reshuffling of manpower, etc.

(½ Mark for each point)

(c) Responsibilities of Joint Auditors: <u>As per SA 299</u> **(½M)**, {in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him} **(1M)**. {In respect of other works, which are not divided, all joint auditors are jointly and severally responsible for} **(1M)**:

(i) Audit work which is not divided and is carried on jointly by all the joint auditors
(ii) Decision taken by all joint auditors concerning the nature, timing or extent of audit procedures to be performed by any of the joint auditors.
(iii) Matters which are brought to the notice of joint auditors by any one of them and on which there is agreement among the joint auditors

(½ Mark for each point)

(iv) Examining the financial statements of the entity comply with the disclosure requirements of the relevant statute ½M

(v) Ensuring that the audit report complies with the requirement of the relevant statute ½M

(d) **Applicable financial reporting framework** – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. **2.5 M**

The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements. **2.5 M**

Answer 5:

(a) **{Understanding of the Company's Automated Environment:** Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment} **(½M)**

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

(½ Mark for each point)

(b) **Purpose of Letter of Engagement:**

{The audit engagement letter is sent by the auditor to his client , which documents the objective and scope of the audit, the extent of his responsibilities to the client and the form of report} **(¾M)**. {The ICAI has issued SA 210, "Agreeing the Terms of Audit Engagement" on the subject} **(½M)**. {It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent **(¾M)**}.

Important Contents of Letter of Engagement: The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

1. The objective and scope of the audit of the financial statements;
2. The responsibilities of the auditor;
3. The responsibilities of management;
4. Identification of the applicable financial reporting framework for the preparation of the financial statements; and
5. {Reference to the expected form and content of any reports to be issued by the auditor} **(½M)** and {a statement that there may be circumstances in which a report may differ from its expected form and content} **(½M)**.

(½ Mark for each point)

(c) Emphasis of Matter paragraph: {Sometimes the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements**(1M)**} {that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report} **(1M)**.

Examples - when it is used:

(i) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
(ii) Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
(iii) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

(¼ Mark for each point)

Manner of its use in Audit Report: As per SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report",**(¼M)** the inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(i) Include it immediately after the Opinion paragraph in the auditor's report;
(ii) Use the heading "Emphasis of Matter", or other appropriate heading;
(iii) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
(iv) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

(½ Mark for each point)

(d) Provisions regarding re-appointment of a Retiring Auditor at the AGM for a Company not covered under Auditor Rotation Provisions: A retiring auditor may be re-appointed at an annual general meeting, if-

(i) {he is not disqualified for re-appointment} **(1M)**;
(ii) {he has not given the company a notice in writing of his unwillingness to be re – appointed}**(1M)**; and
(iii) {a special resolution has not been passed at that meeting appointing some other auditor **(1M)** or {providing expressly that he shall not be re –appointed}**(1M)**.

{Where at any annual general meeting, no auditor is appointed or re -appointed, the existing auditor shall continue to be the auditor of the company **(1M)**}.

Answer 6:

(a) Nature of Security:

(i) Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance. **1M**

(ii) Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset. **1M**

Examples of most common types of securities accepted by banks are the following.

- Personal Security of Guarantor
- Goods / Stocks / Debtors / Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

(½ Mark for each valid example) (Max. 3 Marks)

(b) Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered,

- Inaccurate processing of data, processing inaccurate data, or both **(1M)**
- Unauthorized access to data **(½M)**
- Direct data changes (backend changes) **(½M)**
- Excessive access / Privileged access (super users) **(1M)**
- Lack of adequate segregation of duties **(½M)**
- Unauthorized changes to systems or programs **(½M)**
- Failure to make necessary changes to systems or programs **(½M)**
- Loss of data **(½M)**

(c) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–

(i) Simple random sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of Rs. 5,000 to Rs. 25,000 and not in the range between Rs. 25 to Rs. 2,50,000. **2.5 M**

(ii) Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example in the above case, trade receivables balances may be divided into four groups as follows – **2.5 M**

(a) balances in excess of Rs. 1,00,000;
(b) balances in the range of Rs. 75,000 to Rs. 1,00,000;
(c) balances in the range of Rs. 25,000 to Rs. 75,000; and
(d) balances below Rs. 25,000.

(d) **Applicability of Provisions Related to Rotation of Auditors:** The provisions related to rotation of auditor as provided under section 139(2)**(¼M)** of the Companies Act, 2013 are applicable to all listed companies **(1M)** and other class or classes of companies **(¼M)** as prescribed under Companies (Audit and Auditors) Rules, 2014.

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies **(½M)**–

(i) all unlisted public companies having paid up share capital of Rs.10 crore or more;
(ii) all private limited companies having paid up share capital of Rs.50 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 Rs. 50 crores or more.

(1 Mark for each point) (Max. 3 Marks)

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