(ALL BATCHES)

DATE: 06.10.2018 **MAXIMUM MARKS: 100** **TIMING: 3¼Hours**

PAPER :AUDIT

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.

<u>Answer: 1</u>

(a) **Incorrect:** Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

(b) **Incorrect:**SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

(c) **Incorrect:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

(d) **Incorrect:** The SAs do not ordinarily refer to inherent risk and control risk separately. but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk

(1 Mark for Decision & 1 Mark for reason)

assessments is more important than the different approaches by which they may be made.

(e) **Correct:** An audit is an independent examination of financial information of anyentity, 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.

(f) **Correct:** Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

(g) **Incorrect:** As per SA 230 on "Audit Documentation" the working papers arethe property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

(h) **Incorrect:** Section 138 of the Companies Act, 2013 requiresevery privatecompany to appoint an internal auditor having turnover of Rs. 200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding Rs. 100 crore or more at any point of time during the preceding financial year.

(i) **Correct.** General IT controls support the functioning of automated applicationcontrols and IT dependent controls..

(j) **Incorrect.** The method which involves dividing the population into groupsof items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

Answer: 2

(a) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

(i) The Nature of Financial Reporting: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. **1 Mark**

(ii) The Nature of Audit Procedures. There are practical and legal limitations onthe auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. **1 Mark**

2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(1 Mark for Any 1 point) point

(iii) Timeliness of Financial Reporting and the Balance between Benefit andCost: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

1 Mark

(iv) Other Matters that Affect the Limitations of an Audit: In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

1 Mark

(b) Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

(1Mark)

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

(1 Mark for any 4 point)

Approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures

(c) **The auditor shall establish an overall audit strategy** that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as

1 Mark

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates, and
4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place **(for example, on-site or off-site),** and whether to complete engagement quality control reviews.

(1 Mark Each Point)

(d) **When a business operates in a more automated environment** it is likely that we will see several business functions and activities happening within the systems.
Consider the following aspects,

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation)
- Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic)
- Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically)
- Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report)
- User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively)

(1 Mark Each Point)

Answer:3

(a) Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

2M

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company. **3M**

(b) As per SA 210 on "Agreeing the Terms of Audit Engagements", the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the factors that may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms are discussed in para 14 above. **2M**

Anauditorwho,beforethecompletionoftheengagement,isrequestedto**changethe engagement to one which provides a lower level of assurance, should consider the appropriateness of doingso.**

A request from the client for the auditor to change the engagement may result from-

1. a **change in circumstances** affecting the need for theservice,
2. **a misunderstanding** as to the nature of an audit or related service originally requested.
3. **arestrictiononthescopeoftheengagement**,whetherimposedbymanagement or caused bycircumstances.

(1 Mark Each Point)

(c) **Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. **2M**

The requirements relating to sample design, sample size and selection of items for testing are explained below-

- **Sample design -** When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. **1M**
- **Sample Size-** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. **1M**
- **Selection of Items for Testing-** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. **1M**

(d) The reliability of information to be used as audit evidence, and therefore ofthe audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant.

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

- Audit evidence obtained directly by the auditor (for **example**, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for **example**, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for **example**, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

(1 Mark Each Point)

Answer:4

(a) **Substantive Procedures to be performed to assess the risk of material misstatement**: As per SA 330, "The Auditor's Response to Assessed Risk",substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. **1M**

Test of Details:The nature of the risk and assertion is relevant to the design oftests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
In designing tests of details, the extent of testing is ordinarily thought of in termsof the sample size. **2M**

Substantive Analytical Procedures: Substantive analytical procedures aregenerally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. **2M**

(b) Purchase of Goods on Credit by the Auditor: Section 141(3)(d)(ii) of the Companies Act, 2013 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding five lakh rupees. **2M**

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees five lakh, he is disqualified for appointment as an auditor of the company. **1M**

It will not make any difference if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business. The auditor cannot argue that he is enjoying only the normal credit period allowed to other customers. In fact, in such a case he has become indebted to the company and consequently he has deemed to have vacated his office. **2M**

(c) The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether: **1M**

- The comparative information agrees with the amounts and other disclosures presented in the prior period; and **2M**
- The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed. **2M**

(d) **While obtaining audit evidence about the effective operation of internal controls**, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation. **2M**

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures. **1M**

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows. **2M**

Answer: 5

(a) **Goods Sent on Consignment:**

(i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods inhand.

(ii) Reconcilethefigureofthegoodsonhand,asgiveninthelastaccountssales, withthePerformainvoicesandaccountssalesreceivedduringtheyear.Ifany consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in thereconciliation.

(iii) Obtainconfirmationfromtheconsigneeforthegoodsheldonconsignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debitedtotheconsignmentaccountandcreditedtotheconsignee'saccount. The accounts sales also must be correspondinglychecked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight,dock dues, customs due, etc., unless the value is lower. In case net realisablevalue is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making thevaluation.

(v) Seethatgoodsinhandwiththeconsigneehavebeenshowndistinctlyunder inventories.

(1 Mark for Each Point)

(b) Foreign TravelExpenses:

(i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.

(ii) Verify that the tour programme was properly authorised by the competent authority.

(iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properlypassed.

(iv) See that the tour report accompanies the T.A. bill. The tour report will show thepurposeofthetour.Satisfythatthepurposeofthetourasshownbythe tour report conforms to the authorisation for the tour.

(v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(1 Mark for Each Point)

(c) Receipt of CapitalSubsidy:

(i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been madeavailable.

(ii) Examinedocumentsforthegrantofsubsidyandnotetheconditionsattached with the same relating to its use,etc.

(iii) See that conditions to be fulfilled and other terms especially whether the sameisforaspecificassetorisforsettingupafactoryataspecificlocation.

(iv) Check relevant entries for receipt of subsidy.

(v) CheckcompliancewithrequirementsofAS12on"AccountingforGovernment Grants"i.e.whetheritrelatestospecificamountorintheformofpromoters' contribution and accordingly accounted for as also compliance with the disclosurerequirements

(1 Mark for Each Point)

(d) Provision for Income Tax:

(i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules madethereunder.

(ii) Reviewadjustments,expenses,disallowedspecialrebates,etc.withparticular reference to the last available completedassessment.

(iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands

(iv) Compute tax payable as per the latest applicable rates in the FinanceAct.

(v) Ensure that overall provisions on the date of the balance sheet is adequate havingregardtocurrentyearprovision,advancetaxpaid,assessmentorders, etc.

(vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period underaudit.

(1 Mark for any 5 Point)

Answer: 6

(a) Theauditorshalldetermine,fromthematterscommunicatedwiththosechargedwith governance, those matters that required significant auditor attention in performing the audit.

In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA315. **2M**

(ii) Significant auditor judgments relating to areas in the financial statements that involvedsignificantmanagementjudgment,includingaccountingestimatesthat have been identified as having high estimationuncertainty. **2M**

(iii) The effect on the audit of significant events or transactions that occurred during the period. **1M**

(b) Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.

(½ Mark for each correct Max. 5 Marks)

- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

(c) The special steps involved in such an audit are stated below-

(1) Vouch the receipt on account of entrance fees with members' applications, counterfoilsissuedtothem,aswellasonareferencetominutesoftheManaging Committee.

(2) Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

(3) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctlyadjusted.

(4) CheckttotalsofvariouscolumnsoftheRegisterofmembersandtallythemacross.

(5) See the Register of Members to ascertain the Member's dues which are inarrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the AuditReport.

(6) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with thefees chargeable for the special services rendered, such as billiards, tennis,etc.

(7) Tracedebitsforaselectedperiodfromsubsidiaryregistersmaintainedinrespect ofsuppliesandservicestomemberstoconfirmthattheaccountofeverymember has been debited with amounts recoverable fromhim.

(8) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventoryregisters.

(9) Vouchpurchasesoffoodstuffs,cigars,wines,etc.,andtesttheirsalepricesoasto confirmthatthenormalratesofgrossprofithavebeenearnedontheirsales.The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuationchecked.

(10) Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of theyear.

(11) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody aresatisfactory.

(12) Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the ManagingCommittee.

(½ Mark for each correct Max. 5 Marks)

(d) Reversal of Income :

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

1 Mark

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

2 Marks

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired is there are any communications from borrowers pointing out diff erences in Interest charge, and whether action as justified has been taken in this regard.

2 Marks

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