(GI-1, GI-2, VI-VDI-SI-1,2)

DATE: 01.08.2022 **MAXIMUM MARKS: 100** **TIMING: 3¼ Hours**

PAPER : AUDITING

DIVISION – A (MULTIPLE CHOICE QUESTIONS)

ANSWERS (1-20) CARRY 1 MARK EACH

Answer (1-20) carry 1 Mark each

1. Ans. c
2. Ans. c
3. Ans. d
4. Ans. c
5. Ans. a
6. Ans. c
7. Ans. a
8. Ans. c
9. Ans. c
10. Ans. d
11. Ans. a
12. Ans. b
13. Ans. d
14. Ans. a
15. Ans. d
16. Ans. d
17. Ans. b
18. Ans. b
19. Ans. c
20. Ans. d

ANSWERS (21-25) CARRY 2 MARKS EACH

21. Ans. b
22. Ans. a
23. **Incorrect.** Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.
24. **Incorrect:** As per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is Rs. 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

    Thus fraud involving amount of 20 lakh rupees should be reported to Audit Committee.

25. **Incorrect:** As per SA 240, "The Auditor's Responsibilities Relating to fraud in an Audit of Financial Statements', fraudulent financial reporting may involve manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared, misrepresentation in or intentional omission from, financial statements of events, transaction or other significant information or intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure.

DIVISION B-DESCRIPTIVE QUESTIONS
QUESTION NO. 1 IS COMPULSORY
ATTEMPT ANY FOUR QUESTIONS FROM THE REST

Answer 1:

Examine with reasons (in short) whether the following statements are correct or incorrect : (Attempt any 7 out of 8)

(i) **Incorrect:** "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

(ii) **Incorrect:** If Company X's balance sheet shows building with carrying amount of Rs. 100 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);

All buildings owned and controlled by Company X are included within the carrying amount of Rs. 100 lakh (Completeness assertion).

(iii) **Incorrect:** The securities premium account may be applied by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

(iv) **Incorrect:** The auditor shall modify the opinion in the auditor's report when:

(a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(v) **Incorrect :**

As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.

(vi) **Incorrect :**

Under provisions of Section 143 of the companies Act, 2013, auditor has to report whether the company has adequate internal financial controls with reference to financial statements in place and operating effectiveness of such controls. The auditor has to report on adequacy and effectiveness of internal financial controls only and not internal controls.

{One Mark for Correct or Incorrect and 1 Mark for Explanation}

(vii) **Incorrect :**
An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

(viii) **Incorrect :**
Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

Answer 2:

(a) **Fact of the Case:** In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who 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. **{2 M}**

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 × 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.

Conclusion:

(i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies: **{1/2 M}**

Total Number of Audits available to the Firm	20 x 3	60
Number of Audits already taken by all the partners In their individual capacity	4+6+10	20
Remaining number of Audits available to the Firm		40

(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 **{1/2 M}**
(1) Mr. A can hold: 20 - 4 = 16 more audits.
(2) Mr. B can hold 20-6 = 14 more audits and
(3) Mr. C can hold 20-10 = 10 more audits.

(iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than Rs. 100 crore, 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. **{1/2 M}**

(iv) As per fact of the case, ABC & 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 Rs. 100 crores. In the **{1/2 M}**

given case, out of the 60 private companies, ABC & Co. is offered 45 companies having paid-up share capital of Rs. 110 crore each.
Therefore, ABC & 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 and 40 private companies having paid-up share capital of Rs. 110 crore each in addition to above 20 company audits already holding.

Answer:

(b) **Audit of Advances:** Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. {1/2 M}
In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

(a) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
(b) Advances represent amount due to the bank.
(c) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
(d) There are no unrecorded advances.
(e) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation. {1/2 M Each Point}
(f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
(g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

Answer:

(c) No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. {2 M}
Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries. {1 M}

Answer:

(d) **Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.
In specific terms the **advantages** that flow may be the following:

(i) Sharing of expertise.
(ii) Advantage of mutual consultation.
(iii) Lower workload.
(iv) Better quality of performance.

(v) Improved service to the client.
(vi) Displacement of the auditor of the company taken over in a takeover often obviated.
(vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
(viii) Lower staff development costs.
(ix) Lower costs to carry out the work.
(x) A sense of healthy competition towards a better performance.

{Any Six Each 1/2 Mark = Total 3 Marks}

Answer 3:

(a) In the given case of Ashu Pvt. Ltd., it has paid capital and reserves of Rs. 50 lakh i.e. less than Rs. 1 crore, turnover of Rs. 9 crore i.e. less than Rs. 10 crore. However, it has maximum outstanding borrowings of Rs. 1.40 crore (Rs. 70 lakh + Rs. 70 lakh) collectively from bank and financial institution. **{2 M}**

Therefore, it fails to fulfill the condition relating to borrowings. Thus, CARO, 2016 shall be applicable to Ashu Pvt. Ltd. accordingly. **{2 M}**

Answer:

(b) 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. **{2 M}**

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. **{1 M}**

Answer:

(c) When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following: **{1 M}**

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
(b) Perform inspection or other audit procedures appropriate in the circumstances.

{2 M}

Answer:

(d) The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
(c) Reviewing legal expense accounts.

{3 M}

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. **{1 M}**

Answer 4:

(a) 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. **{1 M}**

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. **{1 M}**

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. **{2 M}**

Answer:

(b) Appointment of First Auditor of Company: Section 139(6) of the Companies Act, 2013 lays down that the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company. **{2 M}**

In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within 30 days of registration of the company. **{2 M}**

In view of the above, the Managing Director of PQR Ltd. should be advised not to appoint the first auditor of the company. **{1 M}**

Answer:

(c) Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. **{1 M}**

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. **{2 M}**

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated. **{2 M}**

Answer 5:

(a) If management refuses to allow the auditor to send a confirmation request, the auditor shall: **{1 M}**

(a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and **{1 M}**

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260. **{1 M}**

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

Answer:

(b) Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications. **{1 M}**

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to- **{1 M}**

(i) the original engagement; or

(ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement. **{1 M}**

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall- **{1 M}**

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

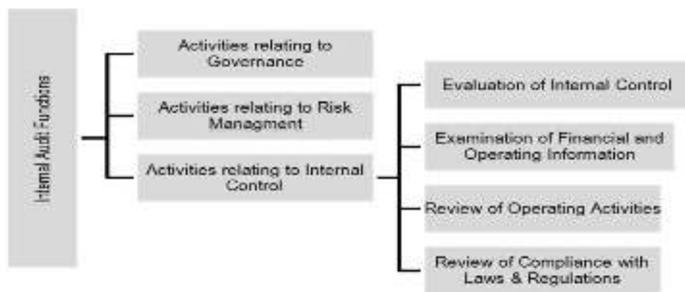
(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Answer :

(c) Who can be appointed as Internal Auditor? As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company. **{1 M}**

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.
The objectives and scope of internal audit functions: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. **{1 M}**

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:



1. Activities Relating to Governance: The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management. **{1/2 M}**
2. Activities Relating to Risk Management: The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud. **{1/2 M}**
3. Activities Relating to Internal Control
   (i) Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit. **{1/2 M}**
   (ii) Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to. **{1/2 M}**

Answer:

(d) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following: **{1 M}**

(i) The selective correction of misstatements brought to management's attention during the audit.

Example **{1 M}**

- ♦ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- ♦ The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives. **{1 M}**

(ii) Possible management bias in the making of accounting estimates.

Answer 6:

(a) 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.
- ♦ 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.

{Any Ten Each 1/2 Mark = Total 5 Marks}

- ♦ 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.

Answer:

(b) The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed. **{2 M}**
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained. **{1 M}**
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained. **{1 M}**
7. The audit methodology and tools used.

Answer:

(c) The auditor shall document:

(a) the overall audit strategy;
(b) the audit plan; and **{1 M}**
(c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit. **{2 M}**

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

For instance-

The following things should form part of auditor's documentation: **{2 M}**

- A summary of discussions with the entity's key decision makers
- Documentation of audit committee pre-approval of services, where required
- Audit documentation access letters
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services
- Auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter)

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