



Book No. 1 (containing 36 pages)

**THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF INDIA**

CA FINAL

Examination

Group No. I Paper No. III

Subject Advanced Auditing & Professional Ethics

Number of Answer Books used.....

For use by ICAI only



CA Final
Audit

Q. No.	Please put ✓ against the Questions answered	Marks Awarded (to be filled by Examiner)					Total
		a	b	c	d	e	
1		3	2	2	2		9
2		4	3	2			9
3							
4		3	2	3			8
5		3 1/2	2	2	4		8 1/2
6		3	3 1/2	2	2		9 1/2
7		2		4	2	2	10
8							
9							
10							
Total		18	12	5	10	2	53

57
FIFTY SEVEN
Fifty three only.

Use only Blue / Black Ball Point Pen to write and shade the circles.
AVOID RED PEN.
Write the marks in the boxes before shading the respective circles.

Total Marks awarded

057

0 0
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Total Marks

Examiner

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(initial of)

INSTRUCTIONS TO THE CANDIDATE

Answers are not to be written on this page

number should be written in figures and words in the allotted space at the right hand corner of the over sheet.

2. Roll number should be written in the box in numbers and darken the appropriate circles of the OMR portion provided in the right hand corner of the cover page with **Black / Blue** ball point pen.
3. Fill particulars such as name of Examination, Group No., Paper No. and subject at the appropriate space at the left hand upper corner.
4. Remove the perforated Bar Code sticker of the particular paper from the Attendance sheet and affix the same on the box provided in the right hand corner of the cover page.
5. Since a machine will read the Roll no., please check and ensure that Roll number written in numbers, words and circles darkened are correct. In case any candidate fills this information wrongly, Institute will not take any responsibility for rectifying the mistake.
6. The answers should be written neatly and legibly
7. The answer to each question must be commenced on a fresh page and question number prominently written at the top of each answer. Alternatively, the question number should be distinctly written in the margin.
8. The answer to each question in all parts should be fully completed in one page, or in a consecutive set of pages, before the next question is taken up.
9. Writing of Roll number in place/s other than the space provided for the purpose or writing distinguishing mark, symbols like "OM", "Sri", "Jesus", "786", etc., will tantamount to adoption of "unfair means"

Que. 5

- (d) Chartered Accountant receiving fees based on % of profits or being contingent upon results of assigned:-

~~Part 10~~ clause 10 of Part I of Ist schedule lays down the criteria that "A chartered accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge professional fees in relation to an assignment which is based on percentage of profits or which is contingent upon results of the assignment unless allowed by ICAI/Council to do so."

However ICAI has carved out 3 exceptions to above rule/clause under which a CA ^{is} _(in practice) not deemed to be guilty of professional misconduct. The said exceptions are listed below

- i) Receiving remuneration as liquidator, fee of which is based on realization of Assets of concern.
- ii) Receiving fees for audit of co-operative society based on % of turnover/profits
- iii) Receiving fees based on % of property, while acting as valuer of property for levy of direct taxes (Income Tax/wealth Tax).

Therefore, in the given case Mr. P is acting as liquidator & receiving the fees based on percentage

of realisation of assets which is an exception to clause 10 of Part I of I schedule as mentioned above.

Therefore Mr. P shall not be liable for guilty of professional misconduct.

- (C) In the given case CA SG (practising CA) has taken up assignment of recruitment of personnel & conducting of training program for & on behalf of client.

Clause 11 of Part I to 1st schedule states that "A chartered accountant in practice shall be deemed to be guilty of professional misconduct if he engages in himself in fulltime employment elsewhere or engages in a profession other than that of a chartered Accountant."

However, it may be noted that the Council has given general permission in respect of some forms of assignment which can be undertaken by a chartered accountant. The work of "selection & recruitment of a personnel & conducting training programs is one of those."

Therefore CA SG is free to undertake the activity of selection & recruitment of personnel as permitted by Council therefore in presence of

✓ Such permission CA 54 shall not be liable for consequences arising from being guilty for professional misconduct.

(b) Partnership with a person other than member of Institute:-

clause 4 of Part 1 to 1st schedule lays down that "A chartered accountant in practice shall be deemed to be guilty of professional misconduct if he enters into a partnership with a person -

- i) other than member of institute
- ii) persons holding relevant qualifications or are members of recognised institut body (ICAI, Bar council, ICAI (cost Accountants) etc.)
- iii) who is resident but for his residence abroad is entitled to be a member under sec 4(i)(v) of the Act
- iv) who is member of such professional body whose membership is recognised by council for entering into such partnerships.

In addition to above we can see that the CA (name not provided) has entered into partnership portraying role of an active partner by participating in course of business viz. representation

operation of bank of accounts, receipts of moneys from clients & managing regular affairs of partnership.

Such activities are deemed to be entering into business/profession other than that of chartered accountant for which he can be held liable for professional misconduct under clause 11 to part I to 1st schedule.

✓ Apart from above, the ~~change~~ chartered accountant in the question has also violated clause 3 of 1st part to 1st schedule of the Act by receiving part of profits of the business/profession other than that of chartered accountant.

Hence, the chartered accountant ~~is~~ concerned in the question would be held liable for professional misconduct under all the clauses mentioned above.

- (a) clause 7 of part I to I schedule of the Act lays down that 'a chartered accountant in practice' (assumed Mr. SP is a CA holding CoP as it is not clearly mentioned in the question) shall be deemed to be guilty of professional misconduct if he advertises his services or

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professional attainment or use any designation other than that of a chartered accountant on letter heads, sign boards or visiting cards unless it be a degree of university recognised by central government or council for the above purpose.

Mr. SP has clearly violated the above provisions of the clause as he has designated himself as "merchant banker" & "advisor to the issue" on offer documents, letterheads, visiting cards & other professional documents.

3 Hence Mr. SP shall be liability liable for professional misconduct under clause 7 of Ist part of I schedule to the Act.

*** [Note: In the analysis of problems mentioned above we have taken following assumptions in view of lack of clarity & contrary information -

- 8
- a) CA SP is holding Certificate of practice
 - b) for acting as advisor to issue & merchant banker he has taken specific permission of Council required as per clause 11 of part 1 of I schedule otherwise he would be held guilty for above act also.]
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Que. 7] a) Core Investment Companies

Core Investment companies are specific / special category of Non-Banking financial company recognised by RBI under RBI (NBFC) Regulations, 1982 which acts as core investment intermediary to the group companies as mentioned under the conditions stipulated under the said regulations

✓ • A core investment company is a NBFC which invests at least 90% or more of its funds in securities of the group companies, (operating under common controller group or common promoter) group

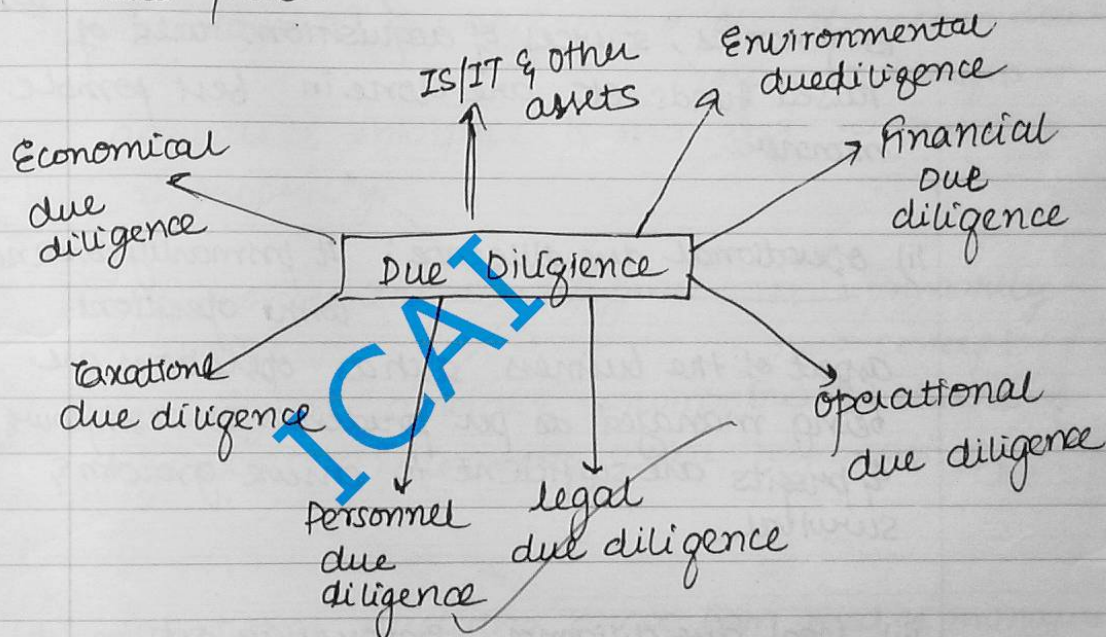
• whose main purpose is only buying & selling the securities held as investments.

• It acts as financier to the group companies by meeting liquidity crunches in critical situations.

• who is registered as core Investment company under RBI & holds a certificate for such category.

- 9
- They are not allowed to make advances or accept deposits from general public.

(c) Areas under which due diligence can take place →



Due diligence is a special type of review-assignment normally carried out on a concern/enterprise when it is going to be transferred as such to another enterprise.

The transferee's enterprise asks for due diligence report from transferor to ensure that there are no legal pending litigations not disclosed by transfer or to check existence of overvalued assets or hidden liabilities in the enterprise. The following are the

main areas of due diligence recognised universally for the above purpose-

- i) Financial due diligence - Enterprise is diligent & cautious in managing its finances, sources of acquisition, use of raised funds etc. are done in best possible manner
- ii) Operational due diligence: It primarily concerns with operations aspect of the business such as operations are being managed as per prudence & cashflows & profits are sufficient to ensure growth & survival.
- iii) Legal due diligence - Enterprise acts in compliance with all the laws enacted which have a bearing on enterprise & are in force
- iv) Taxation due diligence - Enterprise is regular in paying the due taxes & has not pending disputed tax demands, penalties etc. under state & central revenue laws
- v) Personnel due diligence - The employees &

management of the enterprise are proficient & competent to discharge their expected duties & enterprise treats its personnel as assets & not tools.

vi) Economical due diligence → All expenses incurred result in benefits

4 accruals & enterprise is managed with a sense of propriety

vii) Environmental due diligence: It is primarily new concept, focussing on societal & environmental duties of organisation & corporate social responsibility.

(d) operational auditing arose from need of managers responsible for areas beyond direct supervision.

The concept of operational audit is an extension of statutory & financial audit which is rapidly expanding because of its importance to the organisation.

operational audit deals with that the day-to-day operations of managerial organisation are conducted in a manner that the organisational objectives of efficiency,

economy & effectiveness are met.

Thus operational audit venture into ~~that~~ ~~the~~ those technical areas of audit which are hitherto unexplored.

Importance of operational audit to manager to check areas beyond their direct supervision are highlighted as:

- i) A manager being a human being can exercise reasonable control over immediate subordinates & processes with which he is directly concerned. Operational audit focuses on all day to day operations thus focusing / highlighting areas that require immediate overlook.
- ii) The operations of the company work at base level of the organisation thus management through the use of finance audit can't exercise control over wastages & appropriate use of resources.
- iii) The managers are responsible for not only their own processes & functions but for all activities carried out by personnel subordinate to them. Thus management has to look beyond direct supervision into the processes.

(e) Review of internal audit function has become statutory responsibility for statutory auditor."

with the growing importance of internal controls' continued reliance, various enactments by the governments (Companies Act, 2013, ARD, 2003 (now repealed) & various pronouncement & standards issued by ICAI (SA 610 etc.) the internal audit function of the enterprise has fallen into the scope of review of statutory auditor.

i) Implications of SA 610 & relationship/communication between statutory & Internal auditor.

SA 610 'Using the work of internal auditor' states that the statutory auditor is entitled to use the work of internal auditor after following the requirements of professional skepticism & various considerations as

- organisational status of internal audit function
- timeliness & approach of internal auditor
- Competence & relevant qualification of auditor
- due professional care exercised by internal auditor.

2) obligations under Companies Audit, CARO, 2003 (Repealed but reissued under sec. 143(10) of Companies Act, 2013), SEBI regulations etc.

✓ The statutory auditor has obligation to report to various reporting authorities, regulatory authorities & SEBI etc. to state that the internal audit function of the organisation commensurates with the size & nature of business of the company.

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Que-6

(b)

i) Discount allowed in sales invoice →

Discount allowed in sales invoice is usually trade discount offered by the enterprise which is negotiated either before or at the time of sale itself.

Hence, the same does not form part of the turnover & has to be deducted from gross turnover while computing the limit.

(It is a condition of sale) [same for Income Tax & VAT law]

ii) Cash Discount :

cash discount is offered to buyer for prompt / advanced payment of consideration in cash / cheque etc.

The same is not a condition of sale & is offered only when the buyer pays the cash instantly.

Hence it is not deducted while calculating the turnover of assessee. [same for Income Tax & VAT law]

iii) Price of goods returned related to earlier year.

The goods which were returned relating to sale transaction executed in one or more earlier periods doesn't form part of the turnover hence it is deducted from turnover while ~~deduct~~ calculating the limits under ~~both~~ state ~~&~~ VAT Income tax. but ~~not~~ deducted under VAT law.

IV) Sale proceeds of fixed assets.

The treatment of same is different in VAT & income tax as in Income tax it is deducted & doesn't form part of turnover of assessee since it is a capital receipt chargeable to tax under capital gains (if it exceeds WDV)

But in VAT law the fixed assets are treated as goods only & the same is not deducted while calculating the turnover of assessee

Summary

Particulars	Income tax	VAT
(i) Deducted:	✓	✓
(ii) Deducted.	X	X
(iii) Deducted	✓	✗
(iv) deducted	✓	X

d) Appointment & functions of internal auditor

As per Sec. 138 of Companies Act, 2013 any chartered Accountant (whether in practice or not) is entitled to be appointed as internal auditor of the company.

Here, chartered Accountant means

Chartered accountant as per sec. 3 of Chartered Accountants Act, 1949.

Review functions of internal auditor:

- i) Continuous appraisal of ~~the~~ internal controls of enterprise
- ii) Day to day transactions executed are within powers / objects of MoA & AOA & as per authority of personnel.
2. (iii) All significant transactions entered & review of any new systems put in place by management / governance etc.
- iv) All matters of receipts, sales, purchases (according to materiality)
- v) All transactions entered are entered with a view to propriety aspect.
- vi) Review of the whole process of management & conduct of business according to best interests of the company.

a) Role of auditor u/s 143(b) 143B(b) & other requirements as to Companies Act & accounting standards on Auditing.

Sec. 143 (3) (b) lays down the responsibility of auditor to report in its audit report of

the fact that

"All ~~to proper~~ books of accounts & papers as required by the law have been maintained by the company & ~~set~~ proper returns of branches not visited by him have been received from respective branches of the company."

Further the auditor has to comment on the directors responsibility to maintain adequate accounting records →

3 / "In our view the directors have maintained adequate accounting records for the purposes of audit as well as safeguarding the assets of the company & detect frauds & other irregularities."

In respect of SA 705, If auditor is unable to receive sufficient ~~at~~ audit evidence for the purposes of audit it casts a limitation on scope of audit & auditor has to modify his report accordingly as per SA 705.

(C) Stepwise approach adopted by Peer reviewer
Desk check + onsite review

↓
Tests of compliance
on controls of
assurance unit.

↓
Substantive
procedures on the
assurance records
of the unit.

↓
Preliminary report

↓
Further responses.

The approach to be followed by peer reviewer while analysing the peer ~~rev~~ unit / assurance unit differs in circumstances to circumstances but the universal critical steps are aligned below →

Preliminary check & desk review

a) Peer reviewer conducts preliminary check & desk review according to the questionnaire sent by the reviewee / assurance unit

b) on-site review & inspection has to be completed within 7 days.

c) 8-7-0.

The following procedures are adopted by the peer reviewer on units

a) Compliance procedures viz. checking of the internal controls & procedures established & operated by assurance units while conducting assurance assignments

✓ b) Tests of substantive procedures are employed on the working paper & assurance records of unit to check whether the adequate records confirming to a preset level of quantity are maintained by the assurance unit.

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Que-4

(C) In the given case Parent Limited had acquired the majority control (51% shares) in child limited in FY 13-14 thus it was a subsidiary company for the said period, hence the Consolidation was necessary for such period in view of requirements of AS-21 & Sec 129(3) of the Companies Act, 2013.

However, Parent Limited disposed 20% shares in 2014-15 thus the relationship of the child limit was modified from that of a subsidiary to that of Associate.

This requires critical review of AS 21/23 & sec 129(3) of Companies Act, 2013.

AS-21 & AS-23 lay down that the accounts of associates are not consolidated for the purpose of financial statements.

However the new section - Sec. 129(3) of Companies Act lays down that subsidiary includes Joint venture as well as Associate Companies.

sec. 129(3) further lays down that every company in addition to its separate financial statements shall prepare consolidated financial

statements of its subsidiaries in same form & manner as of its own. However if a company is not required by consolidated financial Accounting standard to prepare CFS, it shall be sufficient compliance if the company follows consolidation provisions laid by schedule 3 in this regard. As subsidiaries includes Associates & joint ventures, Parent Ltd. has to prepare consolidated financial statements for the same.

3/

As a Statutory auditor we would advise management to prepare consolidated financial statements in this regard & on refusal shall respond according to modifications to opinion set out under SA 705 accordingly.

- (a) Sec. 141(3)(c)(i) lays down that no person or firm in which a partner holds securities or interest in the company shall be entitled to be appointed as auditor of the company.

Further if the relative of person / partner of firm holds securities / interest in the company of a face value exceeding ₹100,000/-, that firm / person shall

be disqualified to act as an auditor of the company. However, Companies Act 2013, lays down a relaxation that the above condition can be rectified within 60 days to continue to be appointed/act as auditor of company.

3/ Hence, if Mr R opines Mr S to sell the shares of excess face value ₹51,000 within 60 days if Mr S follows the opinion, R & M can be appointed as auditor. Otherwise R & M shall be disqualified to act as an auditor of the company (STPG).

(b) Internal controls are safeguard mechanisms employed by / set by management with overview of those charged with governance to deter the acts of frauds & errors, safeguard the assets of the company & granting a reasonable assurance towards meeting of objectives of efficiency, effectiveness etc.

objectives

i) safeguarding of assets

ii) detection of fraud & errors

iii) ensuring effectiveness & efficiency of company's operations etc.

iv) ensuring moral compliance of company's personnel.

v) To check the processes achieve desired objectives or not.

vi) To bring suspicion about any irregularity, deviation from procedure to the light of management & auditor.

⑧

Que. 1

(a) Implication of SA-710 "Opening Balances" on the problem →

SA 710 lays down that the auditor should gather sufficient appropriate audit evidence as regards to assure himself that opening balances are free from material misstatements & reflect appropriate consistent accounting policies of earlier periods.

- when financial statements were audited previously auditor can peruse the audit report of prior periods to ensure himself about any qualifications etc.
- If financial statements are audited for the first time the auditor should apply the audit procedures to ensure that
 - opening balances are free from material misstatements
 - opening balances reflect appropriate & consistent accounting policies of prior period.
 - opening balances have been correctly brought forward to current period.

→ For current Assets & Liabilities evidence about correctness of opening balances can be obtained

from current year audit procedures (e.g. collection from debtor/receivable during the year) can verify existence, valuation of receivables in prior period.

✓

→ For Inventories, observing current year stock taking & reconciling to the opening periods

→ For Non-current Assets & Liabilities, evidence can be obtained through inspection of current accounting records or inspection external confirmation from 3rd parties.

(C) SAE 3402 "Engagements of sub-service organisation" describes the method of presentation of controls & their relevance to service organisation

controls 1 → Type 1 audit report → existence of controls.

Type 2 - operating effectiveness of controls

Type-1 → Basic information regarding

- Existence of controls
- Controls suit its purpose
- Controls are established to achieve the objectives.

✓ type-2 → operating effectiveness & continued relevance of controls for sub-service organisation.

- (6) SAS 109-820 on special purpose frameworks lays down that auditor should evaluate the management's decision regarding suitability of framework, applied criteria etc.

The considerations which have to be applied are

- i) The given framework is suitable for presentation such that it achieves fair representation as per applied reporting framework.
- ii) management's evaluation regarding applicability of the selected framework in current case
- iii) whether there is adequate disclosure (e.g. emphasis of matter para. or through any other means) that the given financial statements are prepared as per special purpose framework & are unsuitable & unusable for any other purpose
- iv) whether there is adequate disclosure that the financial statements are not meant to be used by third parties other than the company & contract party

✓ 10) The framework doesn't depict the financial transactions & effects in a manner which might be misleading for contract parties.

1(a) The given problem requires comprehensive analysis of SA 320 "Materiality in planning audit of financial statements" & SA 300 "Audit planning & Strategy".

In the given case, Mr. P, auditor of RST Ltd. has made initial assessment of materiality based on past experience, knowledge of business & professional judgement.

However, significant developments can occur through obtaining additional audit evidence later on & they can call for a change in the auditor's perception of materiality for the same.

Mr. P is advised that due to significant developments occurring in later course of audit are to be considered as important perception of materiality changes in planning audit of FS.

Thus the aspects of materiality

previously set by auditor (here, Mr. P) are bound to change & auditor should reflect those changes properly in its documentation & respond to same by changing the quantum of substantive procedures, further alternate audit procedure in response to greater risks conveyed by revaluation of materiality.

3. Thus plan of audit needs to be revised, changes to audit procedures must be done at regular intervals, the nature, timing & extent of further audit procedures & risk audit procedures need to be revised in pursuance to change in level of materiality.

9

Que-2

(b) According to ISA AS 18 one party is said to be related to another during the period of audit if anytime during the period of audit, 1 party has ability to influence the policies of another enterprise. Further according to AS-18 the said control can be exercise by

- controlling majority number of the shares (above 50%) of another enterprise
- controlling the composition of board of directors of another enterprise during any time of financial year.

In the given case though A Ltd. holds only 10% of voting power of enterprise but by virtue of controlling composition of board of directors of B Ltd. B Ltd. is deemed to be a related party.

("Related parties")

SA 550¹ lays down specific & additional considerations for auditor while performing audit of financial statements of the enterprise.

Some of the considerations are listed below:

i) Inquire management & those charged with governance about the related party relationships & all significant transactions with B Ltd. during the year.

ii) The auditor should always keep professional skepticism about the existence & occurrence of related party transaction

iii) The auditor should always remain alert during examinations of misstatements in related party transactions as chances of occurrence of related party transactions are very high.

iv) The auditor should obtain written representation from management & those charged with governance about disclosure of all related party transactions during the period.

v) The auditor should verify statutory records as minutes of meeting of management & those charged with governance, sec. 189 register under companies Act, 2013.

vi) It is duty of auditor to remain alert & identify all possible occurrences of fraud in related party transactions.

(C) Social/ corporate Responsibility under Sarbanes Oxley Act, 2002. →

i) Establishment of PCAOB - Public companies accounting oversight board:-

SOX, 2002 establishes a reporting authorities viz. Public companies accounting oversight board (PCAOB) which is prime reporting authority laying down all disclosure & reporting requirements for all public listed companies.

ii) holding management personally liable for white collar crimes etc.;

SOX, 2002 brings a major reform by holding management personally & criminally liable for the frauds & misstatements effected upon or through white collar crimes viz. insider trading etc.

iii) Periodical returns to regulatory authorities requiring additional disclosures;

SOX 2002 has asked more frequent disclosures & returns & additional disclosures on periodical basis through PCAOB.

IV) Independent Audit committees & liability towards stakeholders.

SOX contains good provisions for maintaining independence of auditors through their appointments, terms of reference, removal & oversight done by an independent audit committee formed for the above purpose.

v) management held personally liable for misstatements & losses to stakeholders:-

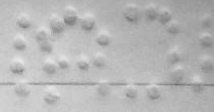
Now top management & executives are personally answerable & liable to revert the losses caused to stakeholders due to misappropriation & fraud on their part.

vi) Significant changes to auditor's appointment, reporting & auditor's liabilities have been envisaged in SOX, 2002 which make auditors increasingly responsible & criminally liable for fraud or collusion with management on their part.

SOX was enacted to make companies (listed) & auditors increasingly responsible for governance & protection of investor's interest which was hurt in view of various scandals as Enron, worldcom etc. (auditor involved - Arthur Andersen & Co.)

- (a) Formulating audit strategy for garment business - online shopping division
 - 1) Provide for checking of general IT controls established on the online shopping platforms.
 - 2) check whether the transactions entered into by customers & company are secured, fully encrypted & free from manual intervention.
 - 3) check whether payments received from the customers online are properly secured, no disclosure of customers credentials like credit card no, pass-word is made.
 - 4) In case of cash on delivery sales, verify that cash has been received within reasonable period of dispatch of order.
 - 5) verify that a proper system of cancellation of customer's order & refund exists to safeguard company against fake refunds, return of damage goods.

- 6) verify that transfers made by physical garment division to online shopping divisions are at appropriate price.
- 7) check whether the source code of data used to compile the company's order processing, payment systems to find irregularities therein.
- 8) verify that proper firewalls, antivirus softwares are installed for safeguarding company's platform from external attacks like hacking etc.
- 9) check whether the recognition of revenue is as per AS-9 (cash on delivery sales on payment basis & others on accrual basis)
- 10) verify the operating effectiveness of internal controls relating to supply chain.
- 11) ensure that proper encryption technologies & regular updates are used by the organisation
- 12) check about the receipt & solving of customer grievances & complaints or frauds, in such case proper deductions have been made from Revenue.



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