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SUBJECT- AUDIT

Test Code - **FNJ 7209**

BRANCH - () (Date :)

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ANSWER-1

ANSWER-A

According to **SA 450 “Evaluation of Misstatements identified during the Audit”**, the following are the sources of misstatements arising from other than fraud –

- (i) An **inaccuracy in gathering or processing data from which the financial statements are prepared** ;
- (ii) An **omission of an amount or disclosure**;
- (iii) An **incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts**; and
- (iv) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

(4*1 = 4 MARKS)

ANSWER-B

Obtaining sufficient appropriate audit evidence while conducting initial Audit Engagement:

According to **SA 510 on “Initial Audit Engagements – Opening Balance”**, the objective of the Auditor while conducting an initial audit engagement with respect to opening balances is to obtain sufficient appropriate audit evidence so that the –

- (i) **Opening balances of the preceding period have been correctly brought forward** to the current period ;
- (ii) **opening balance do not contain any misstatement** that materially affect the current period’s financial statements; and
- (iii) appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Being a new assignment, audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period’s audit procedures. For example, the collection / payment of opening accounts receivable/ accounts payable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as property plant and equipment, investments, long term debts, the auditor will examine the records relating to opening balances. The auditor may also be able to get the confirmation from third parties (e.g. balances of long term loan obtained from banks can be confirmed from the Bank Loan statement).

(6 MARKS)

ANSWER-2

ANSWER-A

External Confirmation : As per SA 505, "External Confirmation", Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of Rs. 25 lacs has not sent the confirmation on the credit balance. In case of non response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

(5 MARKS)

ANSWER-B

Subsequent Events : This case requires attention to SA 560 "Subsequent Events", AS 4 "Contingencies and Events occurring after the Balance Sheet Date" and AS 29 "Provisions, Contingent liabilities and Contingent Assets."

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the will occur.

In the instant case, the amount of 1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements.

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31.3.2017 to the date of Auditors Report i.e. 31.05.2017. It will be observed that as a result of long pending negotiations a sum of 1.50 crores representing arrears of salaries of the year 2015 – 16 and 2016 – 17 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

As per SA 560 “Subsequent Events”, the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

So the auditor should request the management to adjust the sum of 1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

(5 MARKS)

ANSWER-3

ANSWER-A

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

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

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

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

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

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

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

(5 MARKS)

ANSWER-B

Evaluating the Work of Management's Expert : As per **SA 500 "Audit Evidence,"** when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes –

- (1) **Evaluate the competence, capabilities and objectivity of that expert;**
- (2) **Obtain an understanding of the work of that expert;** and
- (3) **Evaluate the appropriateness** of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion :

- (i) The **relevance and reasonableness of that expert's findings or conclusions,** their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- (ii) If the expert's work involves **use of significant assumptions and methods,** the relevance and reasonableness of those assumptions and methods; and
- (iii) If that expert's work involves **significant use of source data, the relevance, completeness, and accuracy of that source data.**

(5 MARKS)

ANSWER-4

ANSWER-A

As per SA **620 “Using the work of an Auditor’s Expert”**, the auditor shall agree, in writing **when appropriate, on the following matters with the auditor’s expert:**

- (i) The **nature, scope and objectives of that expert’s work;**
- (ii) The **respective roles and responsibilities of the auditor** and that expert;
- (iii) The **nature, timing and extent of communication between the auditor and that expert,** including the form of any report to be provided by that expert; and
- (iv) The **need for the auditor’s expert to observe confidentiality requirements.**

In the instant case X Ltd. had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor’s expert to audit valuation of derivatives. Considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor’s expert were new to each other, **auditor should have signed a formal agreement/ engagement letter with the auditor’s expert in respect of the work assigned to him in accordance with SA 220.**

(5 MARKS)

ANSWER-B

As per **SA 402 on “Audit Considerations Relating to an Entity Using a Service Organization”**, when obtaining an understanding of the user entity in accordance with SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”, the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity’s operations, including:

- (i) The **nature of the services provided by the service organization** and the significance of those services to the user entity, including the effect thereof on the user entity’s internal control;
- (ii) The **nature and materiality of the transactions processed** or accounts or financial reporting processes affected by the service organization;
- (iii) The **degree of interaction between the activities of the service organization and those of the user entity;** and
- (iv) The **nature of the relationship between the user entity and the service organization,** including the relevant contractual terms for the activities undertaken by the service organization.

(4*1 = 4 MARKS)

ANSWER-C

- (i) **Special Consideration with Regard to Inventory : As per SA 501 “Audit Evidence – specific Considerations for Selected Items”, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by :**
- (a) Attendance at physical inventory counting, unless impracticable; to
- (1) **Evaluate management’s instructions and procedures** for recording and controlling the results of the entity’s physical inventory counting ;
 - (2) **Observe the performance of management’s count procedures;**
 - (3) **Inspect the inventory;** and
 - (4) **Perform test counts;** and
- (b) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.
- (ii) **Attendance at Physical Inventory Counting Not Practicable** : In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with standards on Auditing”, 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 or to be satisfied with audit evidence that is less than persuasive.

Further, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to be Opinion in the Independent Auditor’s Report, requires the auditor to modify the opinion in the auditor’s report as a result of the scope limitation.

(6 MARKS)

ANSWER-5

(5*1 = 5 MARKS)

1. D
2. D
3. A

4. D

5. C