J.K. SHAH TEST SERIES
Evaluate Learn Succeed

FINAL CA – May 2018
AUDIT (PART 1)

Test Code – F19
Branch (MULTIPLE) (Date : 31.12.2017)

(50 Marks)

Note: ***All*** *questions are compulsory.*

Question 1 (5 marks)

Additional Audit Procedures When Events or Conditions Are Identified: As per SA 570 "Going Concern", when events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. **(1 mark)**

These procedures shall include:

(i) When management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment. **(1 mark)**

(ii) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances. **(1 mark)**

(iii) When the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action: **(1 mark)**

(1) Evaluating the reliability of the underlying data generated to prepare the forecast; and

(2) Determining whether there is adequate support for the assumptions underlying the forecast.

(iv) Considering whether any additional facts or information have become available since the date on which management made its assessment. **(1/2 mark)**

(v) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans. **(1/2 mark)**

Question 2 (5 marks)

Auditor to make Inquiries regarding Management's own Assessment of Risk of Fraud and Controls: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. **(2 marks)**

In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control. **(1 mark)**

The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. **(1 mark)**

Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information. **(1 mark)**.

Question 3 (5 marks)

When the Parent's Auditor is not the Auditor of all its Components: In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of **SA 600 "Using the Work of Another Auditor". (1 mark)**

As per SA 706, When the parent's auditor decides that he will make reference to the audit of the other auditors, the auditor's report on consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s). **(1 mark)**

This may be done by stating aggregate rupee amounts or percentages of total assets and total revenues and cash flows of subsidiary(s) included in consolidated financial statements not audited by the parent's auditor. **(1 mark)**

Total assets, revenues and cash flows not audited by the parent's auditor should be presented before giving effect to permanent and current period consolidated adjustments. **(1 mark)**

However, reference in the report of the auditor of consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries. **(1 mark)**

Question 4 (5 marks)

a) As per **SA 402 "Audit Considerations relating to an Entity Using a Service Organisation"**, for obtaining understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operation including: **(1/2 mark for each point)**

1. The nature of services provided by the service organisation and the significance of such services to the user entity, including its effect on the internal control of user entity.
2. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.
3. The degree of interaction between the activities of the service organization and those of user entity and
4. 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 organisation.

When obtaining an understanding of internal control relevant to the audit in accordance with SA 315 "Identifying and Assessing the Risks of Material Mis-statement through Understanding the Entity and its Environment", the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organization.

(2 marks)

b) The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement**.(1 mark)**

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures: **(1 ½ marks)**

i) Obtaining a Type 1 or Type 2 report, if available;

ii) Contacting the service organisation, through the user entity, to obtain specific information;

iii) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or

iv) Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation

Question 5 (5 marks)

Examples of Accounting Estimates that may have a High Estimation Uncertainty: As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures", the auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. **(1 Mark)**

Examples of accounting estimates that may have high estimation uncertainty include the following: **(1 Mark each)**

i Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.

ii Accounting estimates that are not calculated using recognised measurement techniques.

iii Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.

iv Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.

Question 6 (5 marks)

As per **SA 501 "Audit Evidence – Additional Considerations for Specific Items",** the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. SA 501 is additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures.

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on

(a) the completeness of information provided regarding the inventory, and

(b) assurance with regard to adherence to laid down procedures for physical inventory count.

By following the above procedure, it will be ensured that the physical verification conducted by the management was in order.

Question 7 (5 marks)

Factors Influencing the amount of Working Papers: As per SA 230 "Audit Documentation", which refers to the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached, the amount of audit working papers depend on factors such as-

a) The size and complexity of the entity.
b) The nature of the audit procedures to be performed.
c) The identified risks of material misstatement.
d) The significance of the audit evidence obtained.
e) The nature and extent of exceptions identified.
f) 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.
g) The audit methodology and tools used.

Timely preparation of Audit Documentation

Question 8 (5 marks)

As per SA 620, "Using the work of an Auditor's Expert", some of the matters may affect the level of detail and formality of the agreement between the auditor and the auditor's expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:

i The auditor's expert will have access to sensitive or confidential entity information.

ii The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.

iii Multi-jurisdictional legal or regulatory requirements apply.

iv The matter to which the auditor's expert's work relates is highly complex.

v The auditor has not previously used work performed by that expert.

vi The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

Question 9 (5 marks)

2. SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. **Factors that may affect the identification of an appropriate benchmark include the following:**

(i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

(ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

(iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

(iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

(v) The relative volatility of the benchmark.

Question 10 (5 marks)

a. Audit Risk.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

For purposes of the SAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Three components of audit risk are:

1. Inherent risk (risk that material errors will occur);
2. Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
3. Detection risk (risk that any remaining material errors will not be detected by the auditor). **(2 marks)**

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk - Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures. **(1 mark)**

Control risk - Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The SAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed. **(1 mark)**

Detection risk - For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. **(1 mark)**

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