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SUGGESTED SOLUTION

FINAL MAY 2019 EXAM

SUBJECT- AUDIT

Test Code - FNJ 7048

BRANCH - () (Date :)

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Answer 1:

(A)

Treatment of Employee Benefits Expenses: The present case falls under the category of defined benefit scheme under AS 15 "Employee Benefits". The said scheme encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

- (i) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15.
- (ii) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.
- (iii) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

(B)

Using the Work of Another Auditor : When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and / or to examine the books of account and other records of the said component.

Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures :

- (1) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co – ordination of their efforts at the planning stage of the audit. The principle auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter – component transactions that may require disclosure and the time – table for completion of audit ; and
- (2) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a

completed questionnaire or check – list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor’s knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Further, SA 230 issued by ICAI on Audit Documentation, and “Standard on Quality Control (SQC) 1, “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services engagements”, issued by the institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.”

In the light of aforesaid, principal auditor was not within his right for asking for such sharing of working papers. It depends upon the discretion of auditor.

Answer 2:

(A)

Importance of Actuarial Process and Role of Auditor in case of Life Insurance Business :

Importance of Actuarial Process : Actuaries in Life Insurance business have gained tremendous importance. The role of Actuary in life insurance has shifted from supervising compliance to certify whether products and financial reports are in accordance with the general regulatory guidelines.

The job of actuary or actuarial department in any Life Insurance Company involves, detailed analysis of data to quantify risk. The actuarial department is calculating and modelling hub of the Company. Within the department fundamentals of Insurance business is determined from pricing to policy valuations techniques.

Role of Auditor : Auditors in the Audit report are required to certify, whether the actuarial valuation of liabilities is duly certified by the appointed actuary, including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the authority and / or the Actuarial Society of India in concurrence with the IRDA.

Hence, Auditors generally rely on the Certificate issued by the Appointed Actuary, certifying the Policy liabilities. However, Auditor may discuss with the Actuaries with respect to process followed and assumptions made by him before certifying the Policy liabilities.

Actuarial department broadly concentrates following key areas of Insurance business :

- Product Development / Pricing and Experience analysis.
- Model Development
- Statutory Valuations and reserving.
- Business Planning.
- Solvency management.

Management reporting on various business valuations and profitability models of the Life Insurance business.

(B)

Definition of Key Audit Matters: SA 701 “Communicating Key Audit Matters in the Independent Auditor’s Report”, define Key audit matters as matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

Factors determining Key Audit Matters : As per SA 701 the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following :

- (i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
- (ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimate uncertainty.
- (iii) The effect on the audit of significant events or transactions that occurred during the period.

Answer 3:

(A)

Audit Procedures - In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following :

(a) Evaluation of Internal Controls over Advances :

- Examine loan documentation;
- Examine the validity of the recorded amounts;
- Examine the existence, enforceability and valuation of the security;
- Ensure compliance with the terms of sanction and end use of funds.
- Ensure compliance with Loan Policy of Bank as well as RBI norms including appropriate classification and provisioning
- Review the operation of the accounts;

(b) Substantive Audit Procedures

- Check that amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- Check that advances represent amount due to the bank.
- Verify that amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- Ensure there are no unrecorded advances.
- Check that the stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.

- Verify that the advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements.
- Check that appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
- Examine all large advances while other advances may be examined on a sample basis.
- Verify completeness and accuracy of interest being charged.

(c) Recoverability of Advances :

- Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions.
- Review latest financial statements of borrowers.
- Review reports on inspection of security.
- Review Auditor's reports in the case of borrowers enjoying aggregate credit limits of Rupees 10 lakh or above for working capital from the banking system.

(B)

As per SA 330 on "The Auditor's Responses to Assessed Risks", changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgement. In addition, the length of time between retesting such controls is also a matter of professional judgement.

Factors that may warrant a re – test of controls are –

- (i) A deficient control environment.
- (ii) Deficient monitoring of controls.
- (iii) A significant manual element to the relevant controls.
- (iv) Personnel changes that significantly affect the application of the control.
- (v) Changing circumstances that indicate the need for changes in the control.
- (vi) Deficient general IT – controls.

Answer 4:

(A)

Difference between Internal & Operational Audit : There probably may not be much of difference in viewing operational audit as a review and appraisal to operations of an organisation carried on by a competent independent person. Auditing whether carried on by an internal staff or by an external person, should necessarily be an independent activity to maintain its objectivity and usefulness.

The difference in the approach of both these audits is illustrated below :

1. Perception – Traditionally, internal auditors have been engaged in a sort of protective function, driving their authority from the management. They view and examine internal controls in the financial and accounting areas to ensure that possibilities of loss, wastage and fraud are not there; they check the accounting books and records to see, whether the internal checks are properly working and the resulting accounting data are reliable.

For example – when the auditor looks into the vouchers to see whether they corroborate the entries in the cash book or physically examines the case in hand he is doing his traditional protective function. The moment he concerns himself to see whether customers' complaints are duly attended to or whether cash balance is excessive to the need, he comes to the operational field.

Also he will review the operational control on cash to determine whether maximum possible protection has been given to cash. Similarly, in the audit of stocks, he would be interested in such matters as reorder policy, obsolescence policy and the overall inventory management policy. In pure administrative areas on stock, he will see whether adequate security and insurance arrangements exist for protection of stocks.

2. Issues – the basic difference that exists in conceptualisation of the technique of operational auditing is in the auditor's role in recommending corrections or in installing systems and controls. According to Lindberg and Cohn, such a situation would be in conflict with the role of operational auditor. In this connection, the views of the Institute of Internal Auditors, in the context of internal audit are relevant. According to that Institute, "the internal auditor should be free to review and appraise policies, plans, procedures and records; but his review and appraisal does not in any way relieve other persons in the organisation of the responsibilities assigned to them.

However, a further distinction should be observed between traditional internal auditing and operational auditing – this lies in the attitude and approach to the whole auditing proposition. Every aspect of operational auditing programme should be geared to management policies, management objectives and management goals.

3. Objectives - The main objective of operational auditing is to verify the fulfilment of plans and sound business requirements as also to focus on objectives and their achievement objectives; the operational auditor should not only have a proper business sense, he should also be equipped with a thorough knowledge of policies, procedures, systems and controls, he should be intimately familiar with the business, its nature and problems and prospects and its environment.

Above all, his mind should be open and active so as to be able to perceive problems and prospects and grasp technical matters. In carrying out his work probably at every step he will have to exercise judgement to evaluate evidence in connection with the situations and issues. The norms and standards should be such as are generally acceptable or developed by the company itself.

Performance yardsticks can be found in the management objectives, goals and plans, budgets, records of past performance, policies and procedures. Industry standards can be obtained from the statistics provided by industry, associations and government sources. It should be appreciated that the standards may be relative depending upon the situation and circumstances; the operational auditor may have to apply them with suitable adjustments.

For Example : The standards relating to objectives for a government company are quite different from those of a private sector company. Similarly standards of performance of a well equipped company which also adequately looks after the well – being of employees may be significantly different from a company which offers scanty welfare facilities or is ill – equipped.

Today, however, the concept of modern internal auditing suggests that there is no difference in internal and operational auditing. In fact, the scope of internal auditing is broad enough to embrace the areas covered by operational auditing as well. The modern internal auditing performs both protective as well as constructive functions.

(B)

Reporting under CARO, 2016 for Registration under RBI Act, 1934 : As per Clause (xvi) of paragraph 3 of the CARO, 2016, the auditor is required to report whether the company is required to be registered under section 45 – IA of the Reserve Bank of India Act, 1934. If so, whether the registration has been obtained.

Audit Procedure and Reporting –

- (i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non – Banking Financial Companies.
- (ii) The financial statements should be examined to ascertain whether company’s financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.
- (iii) Whether the company has net owned funds as required for the registration as NBFC.
- (iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

Answer 5:

(A)

Auditor’s responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 “Comparative Information – Corresponding Figures and Comparative Financial Statements”. As per SA 710, When the auditor’s report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor’s opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor’s report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor’s opinion on the current period’s financial statements. In the Basis for Modification paragraph in the auditor’s report, the auditor shall either :

- (i) Refer to both the current period’s figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period’s figures are material; or

- (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

(B)

Liability of Auditor: "It is the auditor's responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is satisfied with the books and documents produced to him, he can give his opinion on the basis of those documents only by exercising requisite skill and care and observing the laid down audit procedure. In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of M/s Cloud Ltd. Therefore, he started investigation of books of accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through the books he found that M/s Cloud Ltd. Used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. Old had negligently performed his duties.

Mr. Old, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is responsible for the books produced before him for audit. He completed his audit work with official set of books only. In this situation, as Mr. Old, performed the auditing with due skill and diligence; and, therefore, no question of negligence arises. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.