SUGGESTED SOLUTION

FINAL MAY 2019 EXAM

SUBJECT- AUDIT

Test Code – FNJ 7171

BRANCH - () (Date :)

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Answer : 1

1. (b)
2. (a)
3. (a)
4. (b)
5. (d)
6. (a)
7. (b)
8. (c)
9. (c)
10. (d)
11. (a)
12. (a)
13. (a)
14. (b)
15. (a)
16. (c)
17. (b)
18. (a)
19. (c)
20. (b)
21. (b)
22. (d)
23. (a)
24. (d)
25. (b)
26. (c)
27. (c)
28. (a)
29. (a)
30. (d)

Answer : 2

(A)

Re – evaluation of the Materiality :

- As per **SA 320 "Materiality in Planning and Performing an Audit"**, the auditor shall determine **materiality for the financial statement as a whole**.
- He shall also set the benchmark on the basis of which he performs his audit procedure.
- In case there are one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could be expected to influence the economic decisions of users, the **auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions**, account balances or disclosures.
- **Revision of materiality** may affect the nature, timing and extent of the further audit procedures also. If auditor becomes aware of information during the audit that would have caused him to have determined a different amount initially, he shall revise materiality level.
- If the auditor determines a **lower materiality**, then he should consider whether it is necessary to revise performance materiality.

- In the present case, Mr. P. auditor of RST Ltd. has applied the concept of materiality for the financial statements as a whole. But he wants to re – evaluate the materiality concept.
- Mr. P can re – evaluate the materiality as per SA 320 as aforesaid, after considering the necessity of such revision. **(5 marks)**

(B)

- As per **SA 500** which deals with audit evidence, managements expert is an individual or organization possessing expertise in a field other than accounting or auditing whose work is used by the entity to assist the entity in preparing the financial statements.
- When information to be used as audit evidence has been prepared using the work of a **management's expert**, the auditor shall evaluate the **competence, capabilities and objectivity** of that expert; he shall obtain an understanding of his work and evaluate the **appropriateness of that expert's work**.
- If after performing the procedures as stated above he is **not satisfied** with the appropriateness of that experts work, **he shall perform extended procedures** including using the work of auditors expert in accordance with SA 620.
- Moreover, pending case for huge sum is an indication that entity may not be continuing as a going concern. He shall **perform procedures in accordance with SA 570 Going Concern as well**.
- In the present case study it is given that ABC Company files a case against Unlucky Company for Rs. 5 Crores. The Unlucky Company merely discloses (no provision) the existence of case in the notes to accounts based upon the advice of attorney of Unlucky Company.
- Thus in the present case study the auditor should perform the procedures as stated above so that he can conclude whether the treatment given by the management is in accordance with appropriate financial reporting framework (Accounting Standard 29).
- If, based upon the evidences obtained, the auditor concludes that a **provision should have been made as per AS 29**; he should request the management to adjust the same. If management does not agree to the same, the auditor should either express a qualified opinion or an adverse opinion. **(5 marks)**

ANSWER : 3

(A)

There may be **certain circumstances which require an adverse or qualified statement** in the auditor's certificate in respect of compliance of the requirements of Corporate Governance. Few of such examples are as follows:

1. An Independent and qualified Audit Committee in not set up.
2. Gap between two meetings of A.C. exceeds 120 days.
3. Chairperson of A.C. is not an Independent director.
4. Chairperson of A.C. not being present at AGM to answer the queries of shareholders.
5. There is no woman director in the company.
6. Disclosures regarding director's remuneration are not made in the Annual Report.
7. Minimum number of Board Meetings was not held or time gap between two Board meetings was more than 120 days.
8. No Independent Director of entity is placed on the Board of its Unlisted Material Subsidiary Company.
9. In the case of Appointment of a Director, his brief resume was not provided to the shareholders.
10. There is no delegation of power of share transfer to a committee/ compliance officer/ share transfer agent. **(6 marks)**

(B)

To management	To Society	To Shareholder	To Government
• Reliable Data • Check on wastage • Inefficiency is identified and corrective action can be taken • It facilitates MBE (management by exception) • Valuation of closing stock • Detection of error and fraud	• Fixation of price • Justification of price increase by increase in cost of production	• It ensures that proper records are kept for materia l, wages etc.	• Cost plus contract • Fixation of ceiling price • Identification of Inefficient unit • Protection to certain industries • Settlement of trade Dispute • Promoting healthy competition among units in industry.

(6 marks)

(C)

Opening Paragraph :

- As **per SA 700 (revised)**, the opening or introductory paragraph identifies the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.
- Within the audit report it is also clarified to the users of financial statements that **preparation of the accounts is the responsibility of the management** of the enterprise.
- The preparation of such statements **requires management to make significant accounting estimates** and judgments and apply the appropriate accounting principles.
- The **responsibility of the auditor** is to express an opinion on the said accounts based on audit carried out by him.
- Thus, it is evident from the paragraph that there is a **clear cut distinction between the duties of management and the auditor**. **(4 marks)**

(D)

- **Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949** prohibits a Chartered accountant in practice from **soliciting** the clients or professional work.
- **Section 140 of the Companies Act, 2013** permits a retiring auditor to make a representation in writing (not exceeding a reasonable length) to the company. [Note: Now covered under section 140(4) of the companies Act 2013]
- The proposition of the partner to highlight contributions made by the firm in strengthening the control procedures in the representation is **not acceptable because the representation letter should not be prepared** in a manner so as to seek publicity.
- The **wording of his representation** should be such that, apart from the opportunity not being abused to secure needless publicity, it does not tantamount directly or indirectly to canvassing or soliciting for his continuance as an auditor.

- He may indicate **<u>in his letter his willingness to continue</u>** as auditor if shareholders in AGM decide so, but this should not be in the nature of solicitation.
- Thus, he will be **<u>guilty of professional misconduct</u>** under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949. **(4 marks)**

Answer : 4

(A) As per **<u>SA – 550 "Related Parties"</u>**, it is auditor's duty to obtain sufficient and appropriate evidences as to whether management has identified all its related parties and made disclosures in the financial statements as per relevant FRF.

It this context, auditor should always remain alter w.r.t. existence of related parties that management intentionally / erroneously did not identified. For existence of related parties, apart from obtaining written representation from management & TCWG, he shall also consider the following :

(1) Entity's organizational structure.
(2) Its shareholding records to identify the principal shareholders.
(3) Investment portfolio of entity (he may identify associates and joint ventures).
(4) LIP such as keyman insurance policies.
(5) Income tax returns wherein some related parties are reflected.
(6) Information submitted to regulatory authority for example SEBI.
(7) Contracts not entered at arm's length price.
(8) Internal auditor's reports.
(9) Minutes of meetings of Board and members (for example, where in section 188 is applicable)
(10) Statutory registers required to be kept w.r.t. transactions with related parties.

(5 marks)

(B)

- As per **<u>Section 143 of the Companies Act, 2013</u>**, The auditor has a **<u>right of access</u>**, at all times, to the books and accounts including all statutory records such as **<u>minute books</u>** etc. of the company for the purpose of audit.
- The auditor may need to refer to the **<u>decisions of the shareholders</u>** or the directors of the company in order to **<u>vouch and verify some of the transactions</u>** of the company.
- It is therefore, **<u>necessary for the auditor</u>** to refer to the Minute Books.
- In the absence of the Minute Books, the auditor may not be able to vouch/ verify certain transaction of the company and ascertain whether these are intra vires or not.
- In the present case, the Board of Directors refused to show the Minute Books to the auditor.
- This being limitation on scope of is work, he may **<u>need to qualify / disclaim his opinion in accordance with SA 705.</u>**

(5 marks)

(C)

- As per **<u>SA 315</u>** the auditor shall identify and assess the **<u>risk of material misstatements</u>** through understanding the entity and its environment.
- He shall **<u>design the responses to risks</u>** in accordance with **<u>SA 330</u>**.
- The auditor shall **<u>use his professional judgment</u>** to assess the audit risk and to design the audit procedures so that risk can be reduced to an acceptability low level.
- Audit Risk has three components:
  (a) Inherent Risk
  (b) Control Risk
  (c) Detection Risk

- Detection Risk is the risk that an auditor's **substantive procedures will not detect** a material misstatement.
- There is an inverse relationship between detection risk and the combined level of inherent and control risks.
- Thus, when **inherent and control risks are high**, acceptable **detection risk should be low** to **reduce the overall audit risk** to an acceptability low level.
- However, the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform substantive procedures.
- If detection risk can't be reduced to acceptability low level, the auditor should express a qualified opinion or a disclaimer of opinion. **(6 marks)**

(D)

To prepare an audit plan in CIS environment, the auditor should gather information about following:

(i) What are the hardware and software being used by the client entity.

(ii) The nature of the processing. Whether client is using batch processing or OLRT systems.

(iii) Extent of computerization in client entity. Whether all its applications are fully computerized.

(iv) Whether there is centralized processing or distributed data processing throughout the client entity.

(v) Organisation and management structure of CIS department. Whether there are sufficient number of capable staff or not.

After obtaining all the relevant information about CIS environment, he should plan to evaluate the reliability of CIS controls so that he can further plan as to whether use of CAAT is required. Thus, he can reduce his overall audit risk in CIS environment to an acceptably low level.

(4 Marks)

ANSWER : 5

(A)

1. As per **Clause 31 of Form 3CD** the particulars of each loan or deposit taken or accepted during the previous year are to be reported in the Tax Audit Report.
2. It also requires reporting in case if the loan or deposit was taken or accepted otherwise than by an account payee cheque/ bank draft. The tax auditor shall also state whether repayment of the same were made by account payee cheque/ bank draft.
3. Thus the tax auditor has to verify the **compliance with the provisions of section 269SS and 269T** of the Income Tax Act.
4. Therefore, in the present case, where the assessee has borrowed Rs. 25 lakhs by way of account payee cheque/ draft and some of them by way of cash, **needs to be scrutinized and reported in Clause 31 of Form 3 CD.**

(4 marks)

(B)

- As per the **section 7 of the Chartered Accountant Act, 1949**, in case a member is suspended and is **not holding Certificate of Practice**, he cannot in any other capacity take up any practice separable from his capacity to practices as a member of the institute.
- This is because **once a member** becomes a member of the institute; he is **bound by the provision of the Chartered Accountants Act, 1949 and its regulations**.
- If he **appears before the income tax** authorities, he is only doing so in **his capability as a chartered accountant** and a member of the institute.

- In the instant case, a chartered accountant not holding certificate of practice cannot take up any other work because it would amount to violation of the relevant provisions of the Chartered Accountants Act, 1949.
- Thus in the present case, a chartered accountant w**ould not be allowed to represent before the income tax authorities** for the period he remains suspended. **(5 Marks)**

(C)

(i) **Working Capital Estimation** : The Company should prepare a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the Master Budget consisting of projected profit and loss and the Balance Sheet.

(ii) **Cash Flow Statement / Cash Budget** : Month – wise cash budgets are required to analyse the major inflows and outflows affecting the entity. At this stage any wasteful outflow can be traced and eliminated. Bank reconciliation should be undertaken periodically so that outstanding can be traced and acted upon.

(iii) **Inventory/ Stock Management** : Raw materials and inventories should be classified properly to determine the level of stock of materials. There should be no unused / obsolete inventory. Just in time philosophy will enable the company to reduce processing time, stocks and related costs. The adoption of such a mechanism would bring down the cost to a considerable extent.

(iv) **Credit Management** : The company should try to avail the maximum credit period from its creditors. The company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age – wise analysis of debtors should also be prepared. The realization process needs to be geared up. This would enhance the working capital of the company.

(vi) **Funds flow Analysis** : The Company should prepare a funds flow analysis, distinguishing between long – term and short – term sources and applications.

(vii) **Investment Management** : the idle funds of the company, if any, should be invested in short – term securities to generate the income.

(viii) **WIP analysis** : Minimum WIP should be kept and it is necessary to ensure a smooth production process. **(6 marks)**

(D)

As per **SA – 260**, which deals communicate the audit matters of governance interest with TCWG, he should consider the form and content of such communication. He shall **determine if communication should be orally or in writing** how much **detailed communication** is required etc. based upon following factors:

1. Sensitivity of matter involved
2. The size and operating structure of the entity.
3. Whether management is already having knowledge of subject matter to be communicated and they do not need detailed information.
4. Legal requirements. Sometimes laws also makes communication mandatory within time frame set by statute for example, reporting of fraud u/s 143(12) to (15) to borad of directors/ audit committee.
5. Arrangements regarding periodical meetings with TCWG.
6. The extent of dialogue between auditor and TCWG.
7. Any change in the governance structure.

(5 marks)

ANSWER : 6

(A)

- As per **Clause 11 of part 1 of First Schedule to the Chartered Accountants Act**, 1949, chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages himself in any BUSINESS/ OCCUPATION other than profession of CA unless permitted by council so to engage.

- However, he may become a director (not MD/WTD) of a company provided he/ his partner is not auditor of such company.
- Member of the institute in practice can engage in full – time or part – time employment only after obtaining the specific and prior approval of the council.
- In the present case, Mr. J has accepted the full time salaried employment in addition to the practice of Chartered Accountancy without obtaining permission of the institute.
- Thus, Mr. J will be **held guilty of professional misconduct.**

(4 Marks)

(B)

- The bank is a consortium member of cash credit facilities of Rs. 50 crores to X Ltd.
- Banks own share is Rs. 10 crores only.
- During the last two quarters against a debit of Rs. 1.75 crores towards interest, the credits in X Ltd's account are to the tune of Rs. 1.25 crores only.
- In case of consortium, each bank may classify the advance given by it according to its own experience of recovery and other factors and not only on the basis of the certificate of lead bank that the account is performing.
- Accordingly, the amount should be shown as non – performing asset.
- Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. **(4 marks)**

(C)

- As per **Clause (7) of part I of second schedule to the CAS Act, 1949**, A C.A. in practice is **deemed to be guilty** of professional misconduct if he **does not exercise DUE DILIGENCE**, or is GROSSLY NEGLIGENT in conduct of his professional duties.
- In the present case, it is given that the auditor did not exercise proper skill and care and performed his work in a desultory and haphazard manner.
- Cash is a very significant item and the fact that the cashier had left during the year without notice itself raises doubt wherein the auditor should have applied professional skepticism.
- As it appears from the facts of the case, the auditor has been grossly negligent in performing his duties which constitutes professional misconduct.
- Thus, he will be guilty of professional misconduct under clause (7) of Part I of Second Schedule to the CA Act, 1949. **(4 marks)**

(D) Assurance services shall not include

(i) Management Consultancy Engagements ;
(ii) Representation before various Authorities ;
(iii) Engagements to prepare tax returns or advising clients in taxation matters;
(iv) Engagements for the compilation of financial statements;
(v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
(vi) Testifying as an expert witness;
(vii) Providing expert opinion on points of principle, such as Accounting Standards; and
(viii) Engagement for De diligence;

The phrase 'Assurance Services' is used interchangeably with Audit Services, Attestation Functions, and Audit Functions. **(4 marks)**

(E)

- As per **Sec. 140(1),** an auditor may be removed from office before the expiry of his term by a **special resolution** in the general meeting and previous approval of central government.
- Thus, it is **difficult to remove** an auditor **before expiry of his term** since adequate grounds must exists to prove that auditor is unsuitable for continuing as an auditor.
- Approval of central government is required **to ensure** that any auditor who is **inconvenient to that management cannot be removed** so easily.
- Thus, such stringent provision provides that auditor **cannot be removed at will by management or shareholders**. Such provisions ensure independence of auditors.

(4 marks)