



**CA Inter Nov 2018**

**Auditing and Assurance**

**Mumbai (Code- INA 3003)**

**17<sup>th</sup> June 2018 (50 Marks)**

**Topics- Audit Strategy, Audit Documentation, Risk Assessment and Internal Control, Fraud, Audit Sampling, Analytical Procedures**

**Question 1**

**State with reasons (in short) whether the following statements are correct or incorrect:**

1. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
2. Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.
3. As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor.
4. Purchase invoice is an example of internal evidence.
5. Sufficiency is the measure of the quality of audit evidence. (5 \* 2 = 10 Marks)

**Answers to Correct/Incorrect**

1. **Correct.** Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.
2. **Incorrect.** The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
3. **Incorrect:** As per SA 230 on "Audit Documentation", the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.
4. **Incorrect:** Internal evidence is the evidence that originates within the client's organisation.

Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

5. **Incorrect:** Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriation is the measure of the quality of audit evidence.

## **Question 2**

A. Explain in brief about the Internal audit function

**(5 Marks)**

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

1. **Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.
2. **Activities Relating to Risk Management:** The internal audit function may assist the entity by identifying and evaluating Significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.
3. **Activities Relating to Internal Control:**
  - (i) **Evaluation of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
  - (ii) **Examination of financial and operating information:** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.
  - (iii) **Review of operating activities:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

- (iv) **Review of compliance with laws and regulations:** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

B. Explain about the Advantages of Statistical sampling in Auditing. (5 Marks)

**The advantages of statistical sampling may be summarized as follows -**

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective and thereby more defensible.
- (3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (4) It provides a means for deriving a “calculated risk” and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

### **Question 3**

A. What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on “Analytical procedures”. (5 Marks)

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) Source of the information available. **For example**, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. **For example**, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (iii) Nature and relevance of the information available. **For example**, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its

completeness, accuracy and validity. **For example**, controls over the preparation, review and maintenance of budgets.

**B.** Points to be considered for constructing an Audit Programme. (5 Marks)

- 1. Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
- 2. Audit Objective and Instruction to Assistants :** The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
- 3. Reliance on Internal Controls :** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.
- 4. Timings of Performance of Audit Procedures :** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.
- 5. Audit Planning :** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

#### **Question 4**

**A.** Limitations of Internal Control (6 Marks)

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

**(i) Human judgment in decision-making:**

Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

**Example**

**There may be an error in the design of, or in the change to, a control.**

**(ii) Lack of understanding the purpose:**

Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

**(iii) Collusion among People:**

Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

**(iv) Judgements by Management:**

Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

**(v) Limitations in case of Small Entities:**

Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

**B. What are the reasons behind management/ employees committing fraud? (4 Marks)**

**Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:**

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

### Question 5

- A. There are many ways for cash defalcation, one of which is by suppressing cash receipts. List out few techniques of how the receipts are suppressed. (6 Marks)

Few techniques of how receipts are suppressed are:

- (1) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- (2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
- (3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
- (4) Not accounting for cash sales fully.
- (5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.
- (6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

- B. Answer the following case-study questions

(2\*2 = 4 Marks)

- (i)** While conducting the audit of Jay Kay Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables but the management refused the auditor to send confirmation request. How would the auditor proceed?

**SOLUTION**

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- (a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

- (ii)** Pride India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements. Suggest the auditor with reference to SAs.

**SOLUTION**

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

- (a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- (b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (c) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been

identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.