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SUGGESTED SOLUTION
INTERMEDIATE N'18 EXAM

SUBJECT- AUDIT

Test Code – CIN 5020

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1. **Incorrect.** Even though specialized audit tools are very useful, such tools are not always required or necessary to carry out data analytics. More commonly available spreadsheet applications like MS-Excel can also be effectively used for carrying out data analytics.
2. **Incorrect.** The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.
3. **Incorrect :** Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.
4. **Incorrect.** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:
 - a. To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
 - b. To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.
5. **Incorrect :** "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.
6. **Incorrect :** If Company X's balance sheet shows building with carrying amount of Rs. 100 lakh, the auditor shall assume that the management has claimed/ asserted that:
 - The building recognized in the balance sheet exists as at the period- end (existence assertion);
 - Company X owns and controls such building (Rights and obligations assertion);
 - The building has been valued accurately in accordance with the measurement principles (Valuation assertion);All buildings owned and controlled by Company X are included within the carrying amount of Rs. 100 lakh (Completeness assertion).
7. **Incorrect:** The provisions of Companies Act, 2013 grant rights to the auditor to access books of account and vouchers of the company. He is also entitled to require information and explanations from the company. Therefore, he has a statutory right to inspect the minute book.
8. **Incorrect.** In the Computerized environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.
9. **Incorrect:** The auditor should study the Memorandum of Association to check the objective of the company to be carried on, amount of authorized share capital etc. and Articles of Association to check the internal rules, regulations and ensuring the validity of transactions relating to accounts of the company.

To see the validity of appointment, the auditor should ensure the compliance of the provisions of section 139, 140 and 141 of the Companies Act, 2013.

In addition, the auditor should study the appointment letter & the prescribed Form submitted to the Registrar of the Companies to see the validity of his appointment.

10. Incorrect: According to section 139 of the Companies Act, 2013, the provisions related to rotation of auditor are applicable to all private limited companies having paid up share capital of Rs. 20 crore or more; and all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of Rs. 50 crore or more.

Although company A is a private limited company yet it is having public borrowings from nationalized bank of Rs. 50 crores, therefore it would be governed by provisions of rotation of auditor.

ANSWER-2

ANSWER-A

(5 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 unauthorized 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.

ANSWER-B

(5 MARKS)

When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems. Consider the following aspects,

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation)
- Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic)
- Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks)

are performed automatically)

- Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report)
- User access and security are controlled by assigning system roles to users (**for example**, segregation of duties can be enforced effectively)

ANSWER-C

(5 MARKS)

Appointment of First Auditor of Company: Section 139(6) of the Companies Act, 2013 lays down that the first auditor or auditors of a company shall be appointed by the Board of directors within 30 days from the date of registration of the company.

In the instant case, the appointment of Shri Ganapati, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within 30 days of registration of the company.

In view of the above, the Managing Director of PQR Ltd. should be advised not to appoint the first auditor of the company.

ANSWER-D

(5 MARKS)

Audit Sampling: As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

ANSWER-3

ANSWER-A

(5 MARKS)

Since an Intangible Asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion.

ANSWER-B

(5 MARKS)

Special points of consideration while auditing certain transactions of a hospital are stated below-

- (i) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
- (ii) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
- (iii) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (iv) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
- (v) **Authorization and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorized.

ANSWER-C

(5 MARKS)

Appointment of Subsequent Auditors in case of Non Government Companies: Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and there after till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

- (i) The company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.
- (ii) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.
- (iii) The certificate shall also indicate whether the auditor satisfies the criteria provided in **section 141**.
- (iv) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

ANSWER-D**(5 MARKS)**

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognized trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

ANSWER-4**ANSWER-A****(8 MARKS)**

Audit of Advances: Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

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

- a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- b. Advances represent amount due to the bank.
- c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- d. There are no unrecorded advances.
- e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognized in their valuation.
- f. The advances are disclosed, classified and described in accordance with recognized accounting policies and practices and relevant statutory and regulatory requirements.
- g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- ◆ examining the validity of the recorded amounts;

- ◆ examining loan documentation;
- ◆ reviewing the operation of the accounts;
- ◆ examining the existence, enforceability and valuation of the security;
- ◆ checking compliance with RBI norms including appropriate classification and provisioning; and
- ◆ carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

ANSWER-B

(6 MARKS)

Substantive Procedures to be performed to assess the risk of material misstatement: As per SA 330, "The Auditor's Response to Assessed Risk", substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Test of Details: The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

Substantive Analytical Procedures: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

ANSWER-C

(6 MARKS)

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:

- (i) 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 principal 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
- (ii) 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.

ANSWER-5

ANSWER-A

(5 MARKS)

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

ANSWER-B**(5 MARKS)**

Understanding and Documenting Automated Environment: Understanding the entity and its automated environment involves understanding how IT department is organized, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

ANSWER-C**(5 MARKS)**

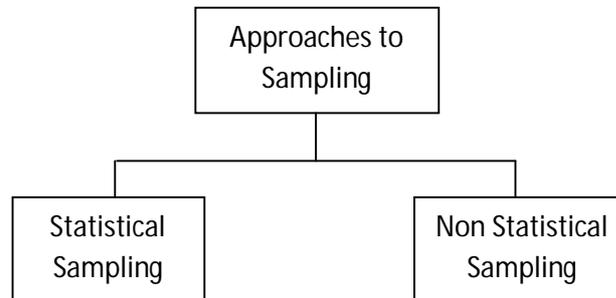
While planning the audit of an NGO, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
- (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions related to the statutes.
- (iii) Reviewing the legal form of the Organization and its Memorandum of Association, Articles of Association, Rules and Regulations.
- (iv) Reviewing the NGO's Organization chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- (v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- (vii) Setting of materiality levels for audit purposes.
- (viii) The nature and timing of reports or other communications.
- (ix) The involvement of experts and their reports.
- (x) Review the previous year's Audit Report.

ANSWER-D

(5 MARKS)

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.



Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered **non-statistical sampling**.

An approach to sampling that has the random selection of the sample items; and

the use of probability theory to evaluate sample results.

the use of probability theory including measurement of sampling risk characteristics.

Characteristics of Statistical Sampling approach

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample must be representative.

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

ANSWER-6

ANSWER-A

(6 MARKS)

Evaluation of Internal Controls over Advances: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- ◆ The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- ◆ All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation ,etc.) should be executed by the parties before advances are made.
- ◆ The compliance with the terms of sanction and end use of funds should be ensured.
- ◆ Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- ◆ If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- ◆ All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- ◆ In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- ◆ Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- ◆ The accounts should be kept within both the drawing power and the sanctioned limit.
- ◆ All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- ◆ The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

ANSWER-B

(4 MARKS)

Liabilities in addition to borrowings (discussed above), include trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity.

Further, a liability is classified as current if it satisfies any of the following criteria:

- It is expected to be settled in the entity's normal operating cycle.
- It is held primarily for the purpose of being traded
- It is due to be settled within twelve months after the reporting period
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments

does not affect its classification.

ANSWER-C

(4 MARKS)

Goods Sent Out on Sale or Return Basis:

- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- (ii) See that price of such goods is unloaded from the sales account and the trade receivable's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
- (iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.
- (iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing inventory.

ANSWER-D

(6 MARKS)

Matters to be included in the auditor's report- statutory dues and repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders (CARO, 2016)–

Clause (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

- (b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).

Clause (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).