



J.K. SHAH[®]
TEST SERIES
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SUGGESTED SOLUTION

CA INTERMEDIATE NOV'19

SUBJECT- AUDIT

Test Code - CIM 8307

BRANCH - () (Date :)

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Answer 1:

(A)

Satisfactory Control Environment – not an absolute deterrent to fraud: The existence of a satisfactory control environment can be a **positive factor** when the auditor assesses the risks of material misstatement. However, although **it may help reduce the risk of fraud**, a satisfactory control environment **is not an absolute deterrent to fraud**. Conversely, deficiencies in the control environment may **undermine the effectiveness of controls**, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

(5 marks)

(B)

Misappropriation of Assets:

It involves the theft of an entity's assets and is often **perpetrated by employees** in relatively **small and immaterial amounts**. However, it can also **involve management who are usually more able to disguise or conceal misappropriations** in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

(1 mark)

- **Embezzling receipts** (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written – off accounts to personal bank accounts).
- **Stealing physical assets** or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- **Causing an entity to pay for goods and services not received** (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

(3 marks)

Example

Vineet is a manager in Zed Ex Ltd. He is having authority to sign cheques up to Rs. 10,000. While performing the audit, Rajan, the auditor, noticed that there were many cheques of Rs. 9,999 which had been signed by Vineet. Further Vineet had split large payments (amounting to more than Rs. 10,000 each, into two or more cheques less than Rs. 10,000 each so that he may authorize the payments). This raised suspicion in the auditor.

The auditor found that the cheques of Rs. 9,999 were deposited in Vineet's personal account i.e. Vineet and misappropriated the amount.

Splitting the cheques into lower amounts involves manipulation of accounts.

The fraud was committed by an employee.

- Using an entity's assets for personal use (for example, using the entity's assets as collateral

for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization. (1 mark)

Answer 2:

(A)

Sufficiency of Audit Evidence: Sufficiency is the measure of the quantity of audit evidence. The quantity of **audit evidence needed is affected by the auditor's assessment of the risks of misstatement** (the higher the assessed risks, the more audit evidence is likely to be required) and also by the **quality of such audit evidence** (the higher the quality, the less may be required). Obtaining more audit evidence, however, **may not compensate for its poor quality**. **Auditor's judgment as to sufficiency may be affected by the factors such as:**

- (i) Materiality
- (ii) Risk of material misstatement
- (iii) Size and characteristics of the population.

(i) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(ii) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) **Size of a population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required. (6 marks)

(B)

Businesses vary in **nature, size and composition**; work which is suitable to one business may not be suitable to others; **efficiency and operation of internal controls** and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of **such variations, evolving one audit programme applicable to all businesses under all circumstances is not practicable**. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any

special matter or any specific situation can be taken care of.

(4 marks)

Answer 3:

(A)

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. **It is also important for him to know whether the system is actually in operation.** Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him **enough time to assimilate the controls** and implications and will **enable him to be more objective in the framing of the audit programme.** He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

(6 marks)

(B)

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. **(4 marks)**

Answer 4:

(A)

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

- (1) **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (2) **Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements. **(5 marks)**

(B)

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by auditors of components and experts. **(5 marks)**

Answer 5:

(1 mark x 10 = 10 marks)

- 1) B
- 2) B
- 3) A
- 4) C
- 5) A
- 6) D
- 7) B

8) C

9) D

10) D