SUGGESTED SOLUTION

INTERMEDIATE N' 2019 EXAM

SUBJECT- AUDIT

Test Code - PIN 5066

BRANCH - () (Date :)

Head Office : Shraddha, 3rd Floor, Near Chinai College, Andheri (E), Mumbai – 69.

Tel : (022) 26836666

Division A- M.C.Q

ANSWER 1:

1. **D**
2. **C**
3. **A**
4. **C**
5. **A**
6. **B**
7. **A**
8. **A**
9. **A**
10. **B**
11. **C**
12. **D**
13. **C**
14. **C**
15. **C**
16. **B**
17. **D**
18. **D**
19. **D**
20. **D**

Division B- Descriptive Questions

ANSWER 1:

1. **Incorrect:** A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).
2. **Correct.** — When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.
3. **Incorrect:** As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.
4. **Incorrect:** As per **section 140(2)** the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form** with the company and the Registrar, and in case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor - General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In this case, the PQR & Co., was also required to file prescribed Form with C & AG of India but it did not file the

same. Therefore, it did not comply with the provisions of the Companies Act, 2013.

5. **Incorrect*:*** Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

6. **Correct:** 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.

   Whatever maybe 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.

7. **Incorrect:** The objective of audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. In auditing, reasonable assurance can be given which is high level assurance but not absolute assurance. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

8. **Correct.** Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

ANSWER 2:

(A)

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.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for **high risk areas** or the **involvement of experts** on complex matters;
2. The amount of resources to allocate to **specific audit areas**, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
3. When these resources are to be deployed, such as whether at an **interim audit** stage or at **key cut-off dates**; and
4. How such **resources are managed, directed and supervised,** such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place **(for example, on-site or off-site),** and whether to complete engagement quality control reviews.

(4 marks)

(B)

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered,

- Inaccurate processing of data, processing inaccurate data, or both
- Unauthorized access to data
- Direct data changes (backend changes)
- Excessive access / Privileged access (super users)
- Lack of adequate segregation of duties
- Unauthorized changes to systems or programs
- Failure to make necessary changes to systems or programs
- Loss of data **(4 marks)**

(C)

The principal aspects to be covered in an audit concerning final statements of account are the following:

(i) <u>**An examination of the system of accounting and internal control**</u> to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

(ii) <u>**Reviewing the system and procedures**</u> to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) <u>**Checking of the arithmetical accuracy of the books of account**</u> by the verification of postings, balances, etc.

(iv) <u>**Verification of the authenticity and validity of transaction**</u> entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) <u>**Ascertaining that a proper distinction has been made between items of capital and of revenue nature**</u> and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) <u>**Comparison of the balance sheet and profit and loss account or other statements with the underlying record**</u> in order to see that they are in accordance there with.

(vii) <u>**Verification of the title, existence and value of the assets**</u> appearing in the balance sheet.

(viii) <u>**Verification of the liabilities**</u> stated in the balance sheet.

(ix) <u>**Checking the result shown by the profit and loss**</u> and to see whether the results shown are true and fair.

(x) <u>**Where audit is of a corporate body, confirming that the statutory requirements**</u> have been complied with.

(xi) **Reporting to the appropriate person / body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organization.

(Students can write any six points among above) (6 marks)

ANSWER 3:

(A)

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate. **(4 marks)**

(B)

Permission of Central Government for Removal of Auditor Under Section 140(1) of the Companies Act, 2013: Removal of auditor before expiry of his term i.e. before he has **submitted his report is a serious matter** and may **adversely affect his independence**.

Further, in case of **conflict of interest** the shareholders may remove the auditors in their own interest.

Therefore, law has provided this **safeguard** so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if **auditor has completed his term** i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the **permission of the Central Government is required** when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term. **(4 marks)**

(C)

The following points merit consideration in regard to scope of audit :

1. The audit should **be organized to cover adequately all aspects of the enterprise** relevant to the financial statements being audited.
2. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether **the information contained in the underlying accounting records and other source data is reliable** and sufficient as the basis for the preparation of the financial statements.
3. In forming his opinion, the auditor should also **decide whether the relevant information is properly disclosed in the financial statements** subject to statutory requirements, where applicable.

4. **<u>The auditor assesses the reliability and sufficiency of the information</u>** contained in the underlying accounting records and other source data by:

   (a) making a **<u>study and evaluation of accounting systems and internal controls</u>** and

   (b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

5. **The auditor determines whether the relevant information is properly disclosed in the financial statements by**:

   (a) **<u>comparing the financial statements with the underlying accounting records and other source data</u>** to see whether they properly summarize the transactions and events recorded therein; and

   (b) considering the judgments that management has made in preparing the financial statements accordingly, the auditor assess the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

   (c) The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

   (d) Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

(6 marks)

ANSWER 4:

(A)

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 who man 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, counter foils 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. **(5 marks)**

(B)

Fraud Risk Factors may be defined as **events or conditions** that indicate an incentive or pressure to **commit fraud** or provide an opportunity to commit fraud.

Examples of Fraud Risk Factors: The fraud risk factors identified here are examples of such factors that may be faced by auditors in a **broad range of situations**. Separately presented are examples relating to the two types of fraud relevant to the auditor's consideration, i.e.,

(A) fraudulent financial reporting, and

(B) Misappropriation of assets. **(4 marks)**

(C)

Review board minutes for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are authorized. Ensure that significant debt commitments should be approved by the board of directors

- Agree details of **loans recorded** (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits imposed by agreements are not exceeded.
- Agree **overdrafts and loans recorded to bank confirmation** / confirmation to lenders.
- Agree details of **leases and hire purchase** creditors recorded to underlying agreement.
- **Examine trust deed** for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a **discharge is received on assets** securing the debt.
- If we become aware of **significant transactions that are outside the normal course** of business or that otherwise appear to be unusual given our understanding of the entity and its environment, perform the following procedures:
  (a) Gain an understanding of the business rationale for such significant unusual transaction.
  (b) Consider whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity we are auditing.

(5 marks)

ANSWER 5:

(A)

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:
   (i) the auditor's **assessment of risk is judgmental** and so may not identify all risks of material misstatement; and
   (ii) there are **inherent limitations to internal control**, including management override.
2. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce **audit risk to an acceptably low level**. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only **tests of details** are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assesse drisks.

3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. **SA 520,** "Analytical Procedures" establishes requirements and provides **guidance on the application of analytical procedures** during an audit.
4. 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.
5. Because the assessment of the risk of material misstatement **takes account of internal control**, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. **(6 marks)**

(B)

Applicability of Section 139(2) Rotation of Auditor: As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

(I) all **unlisted public companies** having paid up share capital of rupees **ten crore or more;**

(II) all **private limited companies** having paid up share capital of rupees **fifty crore or more;**

(III) 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 rupees **fifty cores or more**.

From the above, it can be concluded that rotational provisions would not be applicable.

(4 marks)

(C)

Qualifications and Appointment of Auditors - Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted **persons holding a government diploma in co-operative accounts** **or in co- operation and accountancy** and also a person who has served as an auditor in the co- operative department of a government to act as an auditor.

An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society.

Thus, in view of above provisions, appointment of Mr. M as statutory auditor and Mr. D as tax auditor under Section 44 AB is in order. **(4 marks)**

ANSWER 6:

(A)

Stratification and Value-Weighted Selection: In considering the **characteristics of the population** from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. **SA 530** provides **guidance to the auditor** on the use of stratification and value-weighted sampling techniques.

(1 mark)

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The **objective of stratification is to reduce the variability** of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, **for example, when testing the allowance for doubtful accounts in the evaluation of accounts receivable, balances may be stratified by age.**

The results of audit procedures applied to a sample of items **within a stratum** can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

For **example,** 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the **misstatement is projected for each stratum separately**. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance. **(3 marks)**

Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as **the individual monetary units** that make up the population. Having selected specific monetary units from within the population, **for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.** One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection. **(2 marks)**

(B)

Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

(i) Sharing of expertise.

(ii) Advantage of mutual consultation.

(iii) Lower workload.

(iv) Better quality of performance.

(v) Improved service to the client.

(vi) Displacement of the auditor of the company taken over in a takeover often obviated.

(vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance

(4 marks)

(C)

In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties.

(4 marks)