SUGGESTED SOLUTION

INTERMEDIATE M'19 EXAM

SUBJECT- AUDIT

Test Code – CIM 8157

BRANCH - () (Date :)

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ANSWER-1 (10*1 = 10 MARKS)

1. **D**
2. **C**
3. **B**
4. **D**
5. **C**
6. **D**
7. **D**
8. **C**
9. **C**
10. **A**

ANSWER-2 (5*2 = 10 MARKS)

1. **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.
2. **Correct:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", it is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.
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***:* The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
5. **Incorrect:** Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of Rs. 200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding Rs. 100 crore or more at any point of time during the preceding financial year.

ANSWER-3

ANSWER-A (4 MARKS)

The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.

4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

ANSWER-B **(6 MARKS)**

Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following-

(i) Whether the risk is a **risk of fraud**;

(ii) Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention;

(iii) The **complexity** of transactions;

(iv) Whether the risk involves significant transactions with **related parties**;

(v) The **degree of subjectivity** in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

ANSWER-4

ANSWER-A **(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.

<u>Substantive Analytical Procedures</u>: 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 **<u>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.</u>**

In some cases, even an **<u>unsophisticated predictive model</u>** 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 **<u>use of widely recognised trade ratios</u>** (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-B **(4 MARKS)**

Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions.

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exists when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatements exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

ANSWER-5

ANSWER-A **(6 MARKS)**

Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. **<u>Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.</u>** The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

(a) **Preparing the financial statements** in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the **preparation of financial statements that are free from material misstatement**, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud] and

(b) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a **description of when the use of the going concern basis of accounting is appropriate.**

ANSWER-B **(4 MARKS)**

The Standard on Auditing (SA) 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as-

"an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements.

Two types of intentional misstatements are relevant to the auditor–

- misstatements resulting from **fraudulent financial reporting** and
- misstatements resulting from **misappropriation of assets**.

Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

ANSWER-6

Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]: The auditor is also required to report under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Audit Procedures and Reporting under CARO:

(1) While planning the audit, the auditor should discuss with other members of the audit team, the **susceptibility of the company to material misstatements** in the financial statements resulting from fraud. While planning, the auditor should also **make inquiries of management** to determine whether management is aware of any **known fraud or suspected fraud that the company is investigating.**

(2) The auditor should **examine the reports** of the internal auditor with a view to ascertain **whether any fraud has been reported or noticed by the management.** The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

(3) The auditor should **obtain written representations** from management that:

(i) it acknowledges its responsibility for the **implementation and operation of accounting and internal control systems** that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(iii) it has

(a) disclosed to the auditor all **significant facts** relating to any frauds or suspected frauds known to management that may have affected the entity; and

(b) it has disclosed to the auditor the results of its **assessment of the risk** that the financial statements may be materially misstated as a result of fraud.

(4) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any **uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate**. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the

audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

(1) Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

(i) This clause requires **all frauds noticed or reported** during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, **only noticed frauds shall be included here and not the suspected frauds.**

(iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the **principles of materiality outlined in Standards on Auditing**.

(10 MARKS)