SUGGESTED SOLUTION

INTERMEDIATE MAY 2019 EXAM

SUBJECT- AUDIT

Test Code - PIN 5048

BRANCH - () (Date :)

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Answer 1:

(20*1 = 20 MARKS)

(A)

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

(B)

i) Incorrect: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be arrange of acceptable interpretations or judgments that may be made.

ii) Incorrect: Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

iii) Incorrect: An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

iv) Incorrect: SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

v) Incorrect: When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

vi) Incorrect: As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and
b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

vii) Correct: Teeming and Lading is one of the techniques of suppressing cash receipts Money received from one customer is misappropriated and the account is adjusted with the subsequent receipt from another customer and soon.

viii) Incorrect: There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

ix) Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

x) Incorrect: As defined in scope of Standards on Internal Audit, "Internal Audit means an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system". **(1 mark x 10 = 10 marks)**

Answer 2:

(a) 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 withthem.

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. **(6 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)

Answer 3:

(A)

The level of sampling risk that the auditor is willing to accept affects the sample size required. The **lower the risk the auditor is willing to accept, the greater the sample size will need to be.**

The sample size can be determined by the application of a statistically -based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls:

The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the **operating effectiveness of controls**, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

- If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.

- When there is an increase in the **expected rate of deviation** of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

- An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

- In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population. **(5 marks)**

(B)

<u>"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".</u>

Plans should be made to cover, among other things:

(a) Acquiring knowledge of the client's accounting systems, policies and internal control procedures;
(b) Establishing the expected degree of reliance to be placed on internal control;
(c) Determining and programming the nature, timing, and extent of the audit procedures to be performed; and
(d) co-ordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

<u>SA-300</u>, "Planning an Audit of Financial Statements" further expounds this principle. According to it, **<u>planning is not a discrete phase of an audit</u>**, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. 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. **(5 marks)**

(C)

Trade receivables are an essential part of any organization's balance sheet. Often referred to as debtors, these are monies which are owed to an organization by a customer. The most common form of an account receivable is a sale made on credit, via an invoice, to a customer. Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account.

<u>It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure.</u> In summary, check to ensure that the system for receivables has the following features:

⇢ Only bona fide sales lead to receivables
⇢ All such sales are to approved customers
⇢ All such sales are recorded
⇢ Once recorded, the debts can only be eliminated by receipt of cash or on the authority of a responsible official
⇢ Debts are collected promptly

- ⇢ Balances are regularly reviewed and aged, a proper system of follow up exists and if necessary adequate provision for bad debt exists
- ⇢ Clear segregation of duties relating to identification of debt, receipt of income, reconciliations and write off of debts. **(5 marks)**

(D)

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include **consideration of the qualitative aspects** of the entity's accounting practices, **including indicators of possible bias in management's judgments.** **(1 mark)**

Qualitative Aspects of the Entity's Accounting Practices:

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.

3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit

Example

- ⇢ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

- ⇢ The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.
Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

(1 mark x 4 = 4 marks)

Answer 4:
(A)

In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per **SA 315.** 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) **(5 marks)**

(B)

Matters to be included in the Auditor's Report under CARO, 2016: The auditor's report on the accounts of a company to which CARO applies shall include a statement on the following matters, namely-

(i) **in case the company has accepted deposits**, whether the **directives issued by the Reserve Bank** of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not? **(2 marks)**

(ii) whether the **Nidhi Company** has complied with the Net Owned Funds to Deposits in the **ratio of 1:20** to meet out the liability and whether the Nidhi Company is maintaining ten per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability; **(2 marks)**

(C)

Control Activities - Component of Internal Control

The auditor shall obtain an understanding of control activities relevant to the audit, which the **auditor considers necessary to assess the risks of material misstatement**. An audit requires an understanding of **only those control activities related to significant class of transactions**, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. **(2 marks)**

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels.

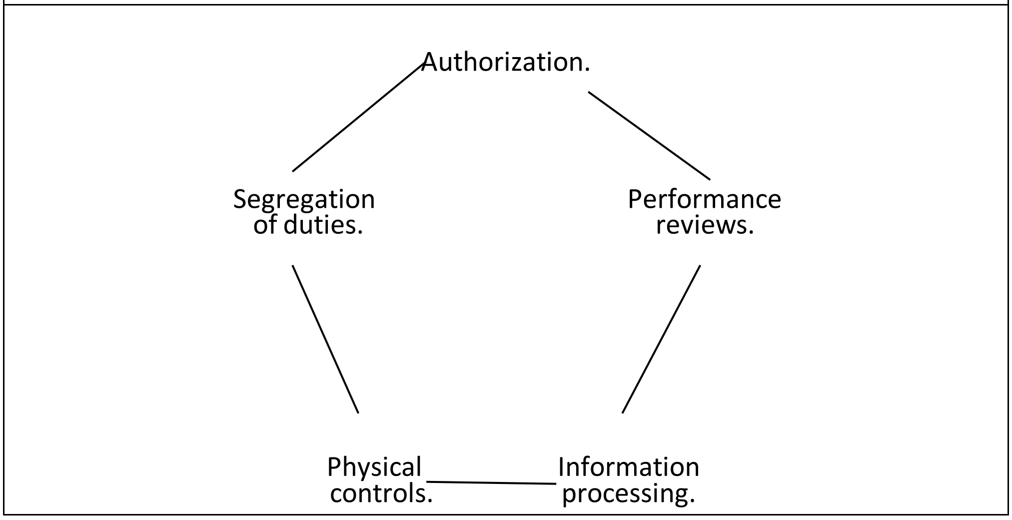
Control activities that are relevant to the audit are:

- Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.; or

- Those that are considered to be relevant in the judgment of the auditor.

- 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.

Examples of specific control activities include those relating to the following:



(4 marks)

(D)

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate. **(1 mark)**

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate. **(2 marks)**

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated. **(2 marks)**

Answer 5:

(A)

Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

(i) **Compile and submit Accounts of Union and States** - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) General Provisions Relating to Audit - It shall be the duty of the C&AG –

- to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

- to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

- to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure** - Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organization, the Comptroller and Auditor General shall scrutinize the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State. **(1 mark x 5 = 5 marks)**

[NOTE : STUDENTS CAN WRITE ANY FIVE POINTS AMONG ABOVE]

(B)

Information which assist the Auditor in accepting and continuing of relationship with Client: As per **SA 220, "Quality Control for an Audit of Financial Statements"** the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client: **(1 mark)**

(i) The integrity of the principal owners, key management and those charged with governance of the entity;

(ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;

(iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and

(iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship. **(1 mark x 4 = 4 marks)**

(C)

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank. **(1 mark x 5 = 5 marks)**

(D)

<u>Circumstances where Retiring Auditor cannot be reappointed:</u> In the following circumstances, the retiring auditor cannot be reappointed-

(i) A specific resolution has not been passed to reappoint the retiring auditor.

(ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.

(iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.

(iv) He has given to the company notice in writing of his unwillingness to be reappointed.

(v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.

(vi) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, **(1 mark x 5 = 5 marks)**

[NOTE : STUDENTS CAN WRITE ANY FIVE POINTS AMONG ABOVE]

Answer 6:

(A)

Depreciation and Amortisation Expenses: Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure that the Company's policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act and applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately has been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used. **(5 marks)**

(B)

Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor. **(5 marks)**

(C)

Auditor's Responsibilities for Detection of Fraud and Error: As per **SA 240 "The Auditor's Responsibilities relating to fraud in an audit of Financial Statements",** an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the **financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.**

Owing to the **inherent limitations** of an audit, there is an **unavoidable risk** that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

When obtaining reasonable assurance, **the auditor is responsible for maintaining an attitude of professional skepticism throughout the audit,** considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error?

The auditor also has the responsibility to **communicate the misstatement to the appropriate level of management on a timely basis** and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the **implications of the frauds and errors**, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. **If adequate disclosure is not made, there should be a suitable disclosure in his audit report. (5 marks)**

(D)

Appropriateness is the measure of the quality of audit evidence: that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. **The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.**

SA 330, "The Auditor's Responses to Assessed Risks" requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the **auditor to draw reasonable conclusions** on which to base the auditor's opinion, is a matter of professional judgment. SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the **balance between benefit and cost, which are relevant factors** when the auditor **exercises professional judgment** regarding whether sufficient appropriate audit evidence has been obtained.

In order to obtain reliable audit evidence, information produced by the entity ("IPE") that is used for performing audit procedures needs to be sufficiently complete and accurate. **(5 marks)**