SUGGESTED SOLUTION

INTERMEDIATE MAY 2019 EXAM

SUBJECT- AUDIT

Test Code - PIN 5066

BRANCH - () (Date :)

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Answer 1: **(1 mark x 20 = 20 marks)**

(A)

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

(B) **(2 marks x 5 = 10 marks)**

(1) Incorrect: The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

(2) 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.

(3) Incorrect: 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.

(4) 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.

(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 2:

(A)

1. Auditing the accounts of a LLP helps in **detecting errors & frauds & verification** of financial statements.
2. **Disputes**, if any between any partners in the matter of accounts can be settled with the help of audited accounts.
3. Banks & financial institutions **lend money to the firms** only on the basis of audited accounts.
4. **Periodical visits & suggestions** by the auditor will be helpful in improving the management of the LLP.
5. For **settling accounts between partners** at the time of admission, death, retirement, insolvency, insanity, etc audited accounts are accepted by those concerned who have dealings with the LLP. **(5 marks)**

(B)

(i) Internal control can provide only reasonable assurance:

Internal control, no matter how effective, can provide an entity with **only reasonable assurance** about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) Human judgment in decision-making:

Realities that human judgment in **decision-making can be faulty** and those breakdowns in internal control can occur because of human error.

(iii) Lack of understanding the purpose:

Equally, the operation of a control may not be effective, such as where information produced for the **purposes of internal control** (for example, an exception report) **is not effectively** used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) Collusion among People:

Additionally, controls can be circumvented by the **collusion of two or more people** or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) Judgements by Management:

Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) Limitations in case of Small Entities:

Smaller entities often have fewer employees due to which **segregation of duties is not practicable.** However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud. **(5 marks)**

Answer 3:

(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)

Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

(a) whether **<u>loans and advances</u>** made by the company on the basis of security have been **<u>properly secured</u>** and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether **<u>transactions of the company</u>** which are represented merely by **<u>book entries</u>** are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of **<u>shares, debentures</u>** and **<u>other securities</u>** have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as **<u>deposits;</u>**

(e) whether **<u>personal expenses</u>** have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any **<u>shares have been allotted for cash</u>**, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading. **(6 marks)**

(D)

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) **<u>Reporting to the appropriate person / body</u>** 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 4:

(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 **<u>submitted his report is a serious matter</u>** and may **<u>adversely affect his independence</u>**.

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

Therefore, law has provided this **<u>safeguard</u>** 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 **<u>auditor has completed his term</u>** 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 **<u>permission of the Central Government is required</u>** 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)

If any advance, including bills purchased and discounted, becomes _as at the close of any year, the **<u>entire interest accrued and credited to income account</u>** in the past periods, should be reversed or provided for if the same is not realised. This will apply to **<u>Government guaranteed</u>** accounts also.

In respect of NPAs, fees, **commission** and similar income that have **accrued should cease to accrue in the current period and should be reversed** or provided for with respect to past periods, if uncollected.

Further, in case of banks which have **wrongly recognized income in the past should reverse** the interest if it was recognized as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the **auditor should enquire** if there are any **large debits** in the Interest Income account that have not been explained. It should be enquired is there are any communications from borrowers pointing out differences in Interest charge, and whether action as justified has been taken in this regard. **(4 marks)**

(D)

Reporting requirements regarding Fixed Assets under CARO, 2016 are:

(a) Whether the company is **maintaining proper records** showing full particulars, including quantitative details and situation of fixed assets;

(b) Whether these **fixed assets have been physically verified** by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) Whether the **title deeds of immovable properties** are held in the name of the company. If not, provide the details thereof; **(3 marks)**

(E)

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. **The auditor assesses the reliability and sufficiency of the information** contained in the underlying accounting records and other source data by:
   (a) making a **study and evaluation of accounting systems and internal controls** 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) **comparing the financial statements with the underlying accounting records and other source data** 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.

Answer 5:

(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. **(3 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 **<u>leases and hire purchase</u>** creditors recorded to underlying agreement.
- **<u>Examine trust deed</u>** for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a **<u>discharge is received on assets</u>** securing the debt.
- If we become aware of **<u>significant transactions that are outside the normal course</u>** 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)

(D)

Evaluations by the Auditor

The auditor shall evaluate whether the financial statements are prepared in accordance with the **<u>requirements of the applicable financial reporting framework.</u>**

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of **<u>possible bias</u>** 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 **<u>qualitative aspects of accounting practices.</u>**
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in **<u>management's judgments</u>**. The auditor may conclude that **<u>lack of neutrality</u>** together with **<u>uncorrected misstatements</u>** 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

- **<u>Correcting misstatements</u>** with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The **<u>combination of several deficiencies</u>** 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. **<u>SA 540</u>** 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. **(4 marks)**

(E)

(a) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. **(1 mark)**

(b) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. **(1 mark)**

Answer 6:

(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 **<u>assessment of risk is judgmental</u>** and so may not identify all risks of material misstatement; and
   (ii) there are **<u>inherent limitations to internal control</u>**, including management override.
2. Depending on the circumstances, the auditor may determine that:
   - Performing only substantive analytical procedures will be sufficient to reduce **<u>audit risk to an acceptably low level</u>**. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
   - Only **<u>tests of details</u>** 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. **<u>SA 520,</u>** "Analytical Procedures" establishes requirements and provides **<u>guidance on the application of analytical procedures</u>** during an audit.
4. The nature of the risk and assertion is **<u>relevant to the design of tests of details.</u>** 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 **<u>takes account of</u>**

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)

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)**

(C)

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)

(D)

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)**