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SUGGESTED SOLUTION

CA INTERMEDIATE M'19

SUBJECT- AUDIT

Test Code - PIN 5074

BRANCH - () (Date :)

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DIVISION –A

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

DIVISION –B

ANSWER-1

(7*2 = 14 MARKS)

- i. **Correct:** Stratified Sampling involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
- ii. **Incorrect:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.
- iii. **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.

- iv. **Correct:** As per SA 220 “Quality Control for an Audit of Financial Statements”, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.
- v. **Incorrect:** The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- vi. **Incorrect:** The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.
- vii. **Incorrect:** Trend analysis is a commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- viii. **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 so on.

ANSWER-2

ANSWER-A

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

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

(4 MARKS)

ANSWER-B

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.

(4 MARKS)

ANSWER-C

A Flow Chart: It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested. It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

(3 MARKS)

ANSWER-D

Shares Issued at discount: According to section 53 of the Companies Act, 2013, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under section 54 of the Companies Act, 2013.

Any share issued by a company at a discounted price shall be void. Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

The auditor needs to verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

(3 MARKS)

ANSWER-3

ANSWER-A

Reliability of Audit Evidence: SA 500 on "Audit Evidence" provides that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalizations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

- (1) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- (2) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- (3) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- (4) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- (5) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

(4 MARKS)

ANSWER-B

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil".

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systems using spread sheets and specialized audit tools viz., IDEA and ACL to perform the following,

- check completeness of data and population that is used in either test of controls or substantive audit tests
- selection of audit samples – random sampling, systematic sampling
- re-computation of balances – reconstruction of trial balance from transaction data
- re performance of mathematical calculations – depreciation, bank interest calculation.
- analysis of journal entries as required by SA 240
- fraud investigation
- evaluating impact of control deficiencies

(4 MARKS)

ANSWER-C

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.

(3 MARKS)

ANSWER-D

The firm's system of quality control should include policies and procedures addressing each of the following elements:

- (a) Leadership responsibilities for quality within the firm.
- (b) Ethical requirements.
- (c) Acceptance and continuance of client relationships and specific engagements.
- (d) Human resources.
- (e) Engagement performance.
- (f) Monitoring.

(3 MARKS)

ANSWER-4

ANSWER-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 whom an 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, counterfoils 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.

(4 MARKS)

ANSWER-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) whether the company has **defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues** to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ii) 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;

(2*2 = 4 MARKS)

ANSWER-C

Assessment of Risks - Matter of Professional Judgement

The assessment of risks is based on audit procedures to **obtain information necessary for that purpose and evidence obtained throughout the audit**. The assessment of risks is a matter of professional judgement, rather than a matter capable of precise measurement.

What is not included in Audit Risk ?

- (i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.
- (ii) Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

(3 MARKS)

ANSWER-D

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to:
- (i) **Evaluate management's instructions and procedures** for recording and controlling the results of the entity's physical inventory counting;
- (ii) Observe the performance of management's count procedures;
- (iii) **Inspect the inventory**; and
- (iv) **Perform test counts**; and

- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(3 MARKS)

ANSWER-5

ANSWER-A

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. 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. 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.

(4 MARKS)

ANSWER-B

Few Techniques of how receipts are suppressed are:

- (1) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
- (2) **Adjusting unauthorized or fictitious rebates,** allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.

- (3) **Writing off as debts** in respect of such balances against which cash has already been received but has been misappropriated.
- (4) **Not accounting for cash sales fully.**
- (5) **Not accounting for miscellaneous receipts**, e.g., sale of scrap, quarters allotted to the employees, etc.
- (6) **Writing down asset values** in entirety, selling them subsequently and misappropriating the proceeds.

(4 MARKS)

ANSWER-C

Applicability of section 177 i.e. Constitution of Audit Committee: Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

It is important to know that in addition to **listed public companies**, following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a **paid up capital of ten crore rupees or more**;
- (ii) all public companies having **turnover of one hundred crore rupees or more**;
- (iii) all public companies, having in **aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more**.

(3 MARKS)

ANSWER-D

The following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) **Source of the information** available. **For example**, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) **Comparability of the information** available. **For example**, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;
- (iii) **Nature and relevance of the information** available. **For example**, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) **Controls over the preparation of the information** that are designed to ensure its completeness, accuracy and validity. **For example**, controls over the preparation, review and maintenance of budgets.

(3 MARKS)

ANSWER-6

ANSWER-A

The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:

- An **opportunity for more experienced engagement team members**, including the audit engagement partner, to **share their insights based on their knowledge of the bank** and its environment.
- An opportunity for engagement team members to **exchange information about the bank's business risks**.
- An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

Errors that may be more likely to occur;

Errors which have been identified in prior years;

Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks; Need to maintain professional skepticism throughout the audit engagement;

Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

(4 MARKS)

ANSWER-B

Trade receivable are an essential part of any organisation's balance sheet. Often referred to as debtors, these are monies which are owed to an organisation 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.

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. 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

(4 MARKS)

ANSWER-C

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.

(3 MARKS)

ANSWER-D

For the purpose of programme construction, the following points should be kept in mind

- (1) Stay within the **scope and limitation of the assignment.**
- (2) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (3) Apply only those steps and **procedures** which are **useful in accomplishing the verification purpose** in the specific situation.
- (4) **Consider all possibilities** of error.
- (5) **Co-ordinate** the procedures to be applied to related items.

(3 MARKS)