SUGGESTED SOLUTION

CA FINAL MAY 2017 EXAM

AUDITING

Test Code - F M J 4 0 1 1

BRANCH - (MULTIPLE) (Date : 22.01.2017)

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Answer-1 (a) :

1. SA 240, "The Auditor's Responsibilities Relating Fraud in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. **(1 Mark)**

2. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. **(1 Mark)**

3. SA 240 also requires that when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. **(1 Mark)**

4. Further, SA 320 Materiality in Planning and Performing an Audit, also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. **(1 Mark)**

5. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. **(1 Mark)**

6. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made. **(1 Mark)**

Answer-1 (b) :

1. SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole. **(0.5 Mark)**

2. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. **(0.5 Mark)**

3. Factors that may affect the identification of an appropriate benchmark include the following:

   (i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses); **(1 Mark)**

   (ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets); **(1 Mark)**

   (iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates; **(1 Mark)**

   (iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and **(1 Mark)**

   (v) The relative volatility of the benchmark. **(1 Mark)**

Answer-2 (a) :

1. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. However, it is the management, which is primarily responsible for identification of related parties. **(1 Mark)**

2. The duties of an auditor with regard to reporting of related party transaction as required by Accounting Standard 18 "Related Party Disclosures" is given in SA 550. **(0.5 Mark)**

   (i)SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator (e.g., prospectuses). **(2.5 Marks)**

   (ii) Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as an arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the establishment of a business relationship through appropriate vehicles or structures, the conduct of certain types of transactions under specific terms and conditions or the provision of designated services or financial support. **(1 Mark)**

   Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include participation in unincorporated partnerships with other parties, agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business, guarantees and guarantor relationships etc. **(1.5 Marks)**

   (iii) Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. **(1 Mark)**

   Examples of transactions outside the entity's normal course of business may include complex equity transactions, such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged, sales transactions with unusually large discounts or returns, transactions with circular arrangements, for example, sales with a commitment to repurchase, transactions under contracts whose terms are changed before expiry etc. **(1.5 Marks)**

   (iv) Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties. **(1 Mark)**

Answer-2 (b) :

1. According to SRS 4410 "Engagements to Compile Financial Information", if an accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading the accountant should withdraw from the engagement. **(1.5 Marks)**

2. As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the stock auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. **(1 Mark)**

3. The tax auditor should also examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains. **(1 Mark)**

4. In the instant case, appointment was made to compile financial statements for tax audit purpose of Yeshaa & Co., a firm. It is our duty of to ensure that method followed for valuation of stock results in disclosure of correct profit and gains. **(0.5 Mark)**

5. In this case the stock valuation was grossly understated. Consequently, disclosure of profit is also not correct. Hence, contention of the Yeshaa & Co., that you are not the conducting an audit, the said figures duly certified by the firm should be accepted is not correct. **(1 Mark)**

Answer-3 (a) :

a) As per SRE 2400 "Engagements to Review Financial Statements", procedures for the review of financial statements will ordinarily include **(Any 8) (Any 8, 1/2 mark each, total 4 marks)**

1. Discuss terms and scope of the engagement with the client and the engagement team.

2. Prepare an engagement letter setting forth the terms and scope of the engagement.

3. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.

4. Inquire whether all financial information is recorded:(a) Completely;(b) Promptly; and(c) After the necessary authorisation.

5. Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.

6. Consider the results of previous audits and review engagements, including accounting adjustments required.

7. Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).

8. Inquire about the accounting policies and consider whether:(a) They comply with the applicable accounting standards;(b) They have been applied appropriately; and(c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.

9. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.

10. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.

11. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.

12. Inquire about contingencies and commitments.

13. Inquire about plans to dispose of major assets or business segments.

14. Obtain the financial statements and discuss them with management.

15. Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.

16. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.

17. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.

18. Consider the effect of any unadjusted errors – individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.

19. Consider obtaining a representation letter from management.

(b) Contrast of a Review Assignment with the Statutory Audit of the Company's Financial Statements with regard to the Scope of the Assignment and to the Report issued is hereunder:

SCOPE

Review assignment	**Statutory audit**
• Scope of Review assignments are generally falls in agreement between parties.	• Scope of Statutory audit should be in accordance with the Companies Act, 2013 or in accordance with other statute.
• Scope of Review assignments are restricted to instructions.	• Scope of Statutory audit should be in accordance with Audit Regulations and Norms.
• Review assignment should be done in accordance with SREs.	• Statutory audit should be conducted in accordance with Engagement and Quality Control Standards, Statements and Guidance Notes etc.

(3 x 1 = 3 Marks)

REPORT

Review assignment	**Statutory audit**
• Report of Review assignment is addressed to the board.	• Statutory Audit Report is addressed to the members.
• Format of Report of Review assignment is wholly discretionary.	• Statutory Audit Report is on true and fair view and as per prescribed Format.
• Report of Review assignment is private report.	• Statutory Audit Reports are in public domain.

(3 Marks)

Answer-3 (c) :

1. As per SA 570 on "Going Concern", it is the responsibility of the Auditor to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

(1 Mark)

2. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

(1 Mark)

3. In the instant case, White Ltd. has suffered massive loss due to introduction of a substitute of its product by its rival company, Yellow Ltd., and having negative net worth also. Besides this, its production head, finance head and marketing head have also left the company. The company, in addition, has no action plan to mitigate these situations. Thus there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate. **(1 Mark)**

4. Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion. **(1 Mark)**

5. If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion. **(1 Mark)**

Answer-4 (a) :
Related SA : 450

According to SA-450 "Evaluation of Misstatements Identified during the Audit", the following are the sources of misstatements arising from other than fraud -

(i) An inaccuracy in gathering or processing data from which the financial statements are prepared;

(ii) An omission of an amount or disclosure;

(iii) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts; and

(iv) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

(4 x 1 = 4 Marks)

Answer-4 (b) :
Ans. Related SA : 315

As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through. Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are-

I. Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both

II. Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.

III. The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down Segregation of duties.

IV. Unauthorised changes to data in Master files

V. Unauthorised changes to systems or programs.

VI. ' Failure to make necessary changes to systems or programs.

VII. In appropriate manual intervention

VIII. Potential loss of data or inability to access data as required.

(8 x 0.5 Marks)