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TEST SERIES

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CA FINAL MAY 2017 EXAM

AUDITING

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Answer-1:

Related SA: 530

These definitions are given in SA 530 (Revised) :

1. Sampling risk –The risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
 - In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
 - In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
2. Tolerable misstatement –A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
3. Tolerable rate of deviation –A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Answer-2 (a) :

1. SA 315 and SA 330 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment” and “The Auditor’s Responses to Assessed Risks” establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. (1 Mark)
2. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. (1 Mark)
3. “Detection risk” is the risk that an auditor’s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. (1 Mark)
4. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. (1 Mark)
5. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. (1 Mark)
6. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate. (1 Mark)

Answer-2 (b) :

1. As per SA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”, the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws. (1.5 Marks)
2. Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements. (1 Mark)

3. In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements. (0.5 Mark)
4. Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case if the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement. (1 Mark)

Answer-2 (c) :

1. As per SA 510 “Initial Audit Engagements—Opening Balances”, in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether: (0.5 Mark)
 - (i) Opening balances contain misstatements that materially affect the current period’s financial statements; and (0.5 Mark)
 - (ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework. (1 Mark)
2. Being new assignment audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements. (1 Mark)
3. For current assets and liabilities some audit evidence can ordinarily be obtained as part of audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period. (1 Mark)
4. In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks). (1 Mark)

Answer-3 :

- a) As per SA 510 “Initial Audit Engagements - Opening Balances”, initial audit engagement is an engagement in which either: (1 Mark)
 1. The financial statements for the prior period were not audited; or (1 Mark)
 2. The financial statements for the prior period were audited by a predecessor auditor. (1 Mark)
- b)
 1. As per SA 610 “Using the Work of Internal Auditors”, while determining whether the work of the internal auditors is likely to be adequate for the purpose of the audit, the external auditor shall evaluate- (1 Mark)
 - (i) the objectivity of the internal audit function; (0.5 Mark)
 - (ii) technical competence of the internal auditors; (0.5 Mark)
 - (iii) whether the work of the internal auditors is likely to be carried out with due professional care; and (0.5 Mark)
 - (iv) whether there is likely to be effective communication between the internal auditors and the external auditor. (0.5 Mark)

3. To determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether the internal auditors have adequate technical training and proficiency; work was properly supervised, reviewed and documented; any reports prepared are consistent with the results of the work performed etc. (1 Mark)
4. In the instant case, CA. Krish should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors. (1 Mark)
5. If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor. (1 Mark)

Answer-4 (a) :

1. SA 705 "Modifications to the Opinion in the Independent Auditor's Report" provides the consequence of an inability to obtain sufficient appropriate audit evidence due to a management – imposed limitation after the auditor has accepted the engagement. (1 Mark)
2. The practicability of resigning from the audit may depend upon the stage of completion of the engagement at the time that management imposes the scope limitation. (1 Mark)
3. When the auditor concludes that resignation from the audit is necessary because of a scope limitation, there may be a professional, regulatory or legal requirement for the auditor to communicate matters relating to the resignation from the engagement to regulators or the entity's owners. (1 Mark)
4. In the case of resignation from the company, provisions of the Companies Act, 2013 applies. Section 140(2) of the Companies Act, 2013, requires the auditor, who has resigned from the company, to file within a period of 30 days from the date of resignation, a statement with the company and the registrar, and in case of government companies, the auditor shall file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor will be liable for penal provisions. (2 Marks)

Answer-4 (b) :

1. This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date". (1 Mark)
2. As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate. (1 Mark)
3. AS 4 also requires disclosure of the non-adjusting event, in the report of the approving authority. (1 Mark)
4. Further, as per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed. (1 Mark)
5. The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. Thus, it will have no effect on items appearing at the balance sheet date because as per AS 4 "Contingencies and Events Occurring after Balance Sheet Date" have to be adjusted that provide evidence of conditions existing as at the balance sheet date. However, the

auditor has to ensure that this loss will not materially affect the substratum of the enterprises as per its size, nature and complexity of operations. (1 Mark)

6. Thus, subject to satisfaction in respect of non-violation of going concern concept, the company has correctly accounted by not providing provision. However, the auditor is required to ensure the proper disclosure of abovementioned event. (1 Mark)

Answer-4 (c) :

1. As per SA 505, "External Confirmation", Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations. (1 Mark)
2. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. (1 Mark)
3. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise. (1 Mark)
4. In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Galaxy Limited. One of the old outstanding of rupees 25 lacs has not sent the confirmation on the credit balance. In case of non response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not mean that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request. (2 Marks)
5. But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts. (1 Mark)