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CA FINAL NOVEMBER 2016 EXAM

AUDIT

Test Code - F N J 6 0 0 6

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Head Office : Shraddha, 3rd Floor, Near Chinai College, Andheri (E), Mumbai – 69.

Tel : (022) 26836666

Answer-1 (a) :

- (a) **Assessment of Risk and Acceptable Level:** 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. 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. "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. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. 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. 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.

(3 Marks)

- (b) **Errors in Valuation of Inventories and Auditor's Responsibilities:** SA 240, "The Auditor's Responsibilities Relating to 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. 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. 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. 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. 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. 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.

(3 Marks)

Answer-1 (b) :

Basic Elements of Auditor's Report: As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements:

- (a) A title;
- (b) An addressee, as required by the circumstances of the engagement;
- (c) An introductory paragraph that identifies the financial statements audited;
- (d) A description of the responsibility of management (or other appropriate term) for the preparation of the financial statements;
- (e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:
 - A reference to Standards on Auditing and the law or regulation; and
 - A description of an audit in accordance with those Standards;
- (f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework);
- (g) The auditor's signature;
- (h) The date of the auditor's report; and
- (i) The place of signature.

(All points are compulsory 6 Marks)

Answer-2 (a) :

- (a) **As per SA 402 on "Audit Considerations Relating to an Entity Using a Service Organisation"**, when obtaining an understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:
- (i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;
 - (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
 - (iii) The degree of interaction between the activities of the service organisation and those of the user entity; and
 - (iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

(4 x 1 = 4 Marks)

- (b) As per SA 240 on The Auditors Responsibilities Relating to Fraud in an Audit of Financial Statements, fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

Keeping in view the above, it is clear that Company has passed fictitious journal entries near year end to manipulate the operating results. Also Auditor's enquiry elicited a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service, is not acceptable.

Accordingly, the auditor would adopt the following approach-

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

- (i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- (ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
- (iii) If the auditor withdraws:
 - (1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
 - (2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

(3 x 1 = 3 Marks)

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

(1 Mark)

Answer-2 (b) :

Evaluating the Work of Management's Expert: As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,-

- (a) Evaluate the competence, capabilities and objectivity of that expert;
- (b) Obtain an understanding of the work of that expert; and
- (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

(1 Mark)

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

(2 Marks)

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

- (i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- (ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- (iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

(3 x 1 = 3 Marks)

Answer-3 (a) :

Steps before Commencing the Audit Work: When one of the joint auditors of the previous year is considered for ratification by the members as the sole auditor for the next year, it is similar to non re-appointment of one of the retiring joint auditors. The provisions of section 140 of the Companies Act, 2013 (hereinafter referred as the Act) relating to non-reappointment of the retiring auditor need to be considered. As per sub-section 4 of section 140 of the Act, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall

not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the Act.

(2 Marks)

The following steps should be taken care of by M/s. PQR before commencing the audit:

- (i) Ascertain that special notice under Section 140(4) of the Act was duly received by the company, from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice, not earlier than three months but at least 14 days before the AGM date as per Section 115 of the Act read with the Companies (Management and Administration) Rules, 2014.
- (ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Act.
- (iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.
- (iv) Verify that the said notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Act.
- (v) Verify whether any representation received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent as per Section 140(4)(iii) of the Act.
- (vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.
- (vii) Examine that proposed resolution was properly passed.

(7 x 0.5 = 3.5 Marks)

Further, Clause (8) of Part I of the First Schedule to the Chartered Accountants Act, 1949, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts a position as auditor previously held by another chartered accountant without first communicating with him in writing.

Moreover, Clause (9) of Part I of the same Schedule, provides that a member in practice shall be deemed to be guilty of professional misconduct if he accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Sections 224 and 225 of the Companies Act, 1956 (now Section 139 and 140 read with section 141 of the Companies Act, 2013), in respect of such appointment have been duly complied with.

(1.5 Marks)

Therefore, M/s PQR is required to comply with all the above mentioned provisions provided under Companies Act and Chartered Accountant Act before commencing the audit.

(1 Mark)

Answer-3 (b) :

Appointment of the Auditor: Section 141 of the Companies Act 2013 (herein after referred as the Act) deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the Section 141 of the Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in the employment of the company as a director or key managerial personnel.

(1 Mark)

Further, as per Council Guidelines, 2008 a member of the institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons, who are his relatives within the meaning of AS-18, have either by themselves or in conjunction with such member, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

(1 Mark)

In the instant case, Mr. Ram is the relative of a Director of the company, therefore, he should not accept the appointment as an auditor of that company. If he accepts such appointment, he would be guilty of professional misconduct and would also be liable for punishment for contravention of the provisions of the Companies Act.

(2 Marks)

Answer-4 (a) :

Branch Audit: As per section 143(8) of the Companies Act, 2013 if a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

(3 Marks)

In the given situation, A Ltd. is a Chennai based company, having total turnover of Rs. 10 Crore. The company is having a branch office at an area which is recently affected by flood.

Therefore, the company has to get its branch audited. In case no branch audit has been carried out, company's auditor is required to mention this fact in the audit report and deal appropriately. Thus, no reference of above branch in statutory auditor's report is not correct.

(1 Marks)

Answer-4 (b) :

(a) **Indebtedness to the Subsidiary Company:** As per sub-section (3)(d)(ii) of Section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of Rs. 5 lakhs.

Also, as per sub-section (4) of Section 141 of the Companies Act, 2013, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.

In the present case, Mr. Savy, the relative of Mr. Navy, a partner in Navy and Cavy Associates, has been indebted to Wealthy Ltd., a subsidiary company of Poor Ltd., for Rs. 6 lakhs.

Therefore, the firm, Navy and Cavy Associates would be disqualified to be appointed as statutory auditor of Poor Ltd. as per section 141(3)(d)(ii), which is the holding company of Wealthy Ltd.,

because Mr. Savy, the relative of Mr. Navy, a partner in Navyand Cavy Associates, has been indebted to Wealthy Ltd. for an amount exceeding the minimum approved limit.

(3 Marks)

- (b) Disqualification due to Holding of Securities: According to section 141(3)(d)(i) of the Companies Act, 2013 read with Rule 10 of the Companies (Audit and Auditors) Rule, 2014, an auditor is disqualified to be appointed as an auditor if he, or his relative or partner holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

However, as per the proviso to this Section, the relative of the auditor may hold these securities or interest in the company of face value not exceeding of Rs. 1,00,000.

Further, the term "relative" has been defined under the Companies Act, 2013 which means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son's wife, Daughter, Daughter's husband, Brother (including step- brother), Sister (including step- sister).

In the present situation,

- (i) Mr. Pratiq is holding securities in Opus Ltd., which is not allowed as per the provisions of section 141(3)(d)(i) of the Act. Therefore, Mr. Pratiq will be disqualified to be appointed as an auditor of Opus Ltd.
- (ii) Mr. Quresh, the step-father of Mr. Pratiq, is holding the securities in Opus Ltd. It may be noted that step-father is included in the definition of the term "relative" as per the Companies Act, 2013. Further, proviso to section 141(3)(d)(i) of the Act allows a relative of the auditor to hold securities in the company of face value not exceeding of Rs. 1,00,000. Here, Mr. Quresh is holding securities for face value of Rs. 89,000 which is below the limit as prescribed under the said proviso. Therefore, Mr. Pratiq will not be disqualified to be appointed as an auditor of Opus Ltd.

(5 Marks)