SUGGESTED SOLUTION

IPCC May 2017 EXAM

AUDITING

Test Code - I N J 1 0 0 1

BRANCH - (Multiple) (Date : 15.01.2017)

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Ans. 1 (a) In planning and performing his examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are: **(1 Mark)**

(i) **Weaknesses in the design of internal control system and non-compliance** with the laid down control procedures, e.g., a single person is responsible for the receipt of all document and marking it to the relevant sections or two persons are responsible for receipt of document but the same is not followed in actual practice, etc. **(1 Mark)**

(ii) **Doubts about the integrity or competence of the management,** e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc. **(1 Mark)**

(iii) **Unusual pressures within the entity,** for example, industry is doing well but the company is not performing accordingly, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc. **(1 Mark)**

(iv) **Unusual transactions** such as transactions with related parties, excessive payment for certain services to lawyers, etc. **(1 Mark)**

(v) **Problems in obtaining sufficient and appropriate audit evidence,** e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc. **(1 Mark)**

Ans.1. (b) **Auditing versus Investigation:** As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. **(2 Marks)**

Audit is generally objected to find out whether the accounts show true & fair view. It is a critical examination of books of accounts. **(0.5 Mark)**

Investigation on the other hand is critical examination of the accounts with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, e.g., the extent of waste and loss, profitability, cost of production etc. It extends scope beyond books of accounts. **(0.5 Mark)**

For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe. Fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the prima facie findings of the auditor. **(1 Mark)**

As per sub section 12 of section 143 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. **(2 Marks)**

Ans. 2 (a) **Concept of Materiality:** Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements; **(1.5 Marks)**
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and **(1.5 Marks)**
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. **(1.5 Marks)**

1. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference. **(1 Mark)**

2. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users: **(1 Mark)**

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence; **(0.5 Marks)**

(b) Understand that financial statements are prepared, presented and audited to levels of materiality; **(0.5 Marks)**

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and **(0.5 Marks)**

(d) Make reasonable economic decisions on the basis of the information in the financial statements. **(0.5 Marks)**

3. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. **(1.5 Marks)**

Ans.2. (b) These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions **(0.5 Marks)**

(i) The asset or a liability should exist at a given date. **(0.5 Marks)**

(ii) The asset should be owned by the entity and the liability is an obligation of the entity at a given date. **(0.5 Marks)**

(iii) There should not be any unrecorded assets, liabilities or transactions. **(0.5 Marks)**

(iv) Assets or liabilities should be recorded at appropriate carrying values. **(0.5 Marks)**

(v) Transaction or event that took place should pertain to the entity during the relevant period. **(0.5 Marks)**

(vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period. **(0.5 Marks)**

(vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any. **(0.5 Marks)**

Ans.3. (a) Management Representation: SA 580 "Written Representations" <u>deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance.</u> **(1 Mark)**

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, <u>similar to responses to inquiries, written representations are audit evidence.</u> **(1 Mark)**

In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, <u>a representation by management may be the only audit evidence which can reasonably be expected to be available</u> for example, intention of management to hold a specific investment for long term. **(1 Mark)**

However, <u>it cannot be a substitute for other audit evidences expected to be available.</u> **(1 Mark)**

Ans.3. (b) Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

i) Materiality. **(0.5 Marks)**

ii) The significance of the related risk **(0.5 Marks)**

iii) The size of the entity. **(0.5 Marks)**

iv) The nature of the entity's business, including its organisation and ownership characteristics. **(0.5 Marks)**

v) The diversity and complexity of the entity's operations. **(0.5 Marks)**

vi) pplicable legal and regulatory requirements. **(0.5 Marks)**

vii) The circumstances and the applicable component of internal control. **(0.5 Marks)**

viii) The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations. **(0.5 Marks)**

ix) Whether, and how, a specific control, individually or in combination with others, prevents, or detecsts and corrects, material misstatement.

Q.4. (a) Weaknesses in the Internal Control System:

Following two essential features of internal control are relevant here-

(i) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end, and

(ii) Segregation of accounting and custodial functions. **(2 Marks)**

Weakness in internal control system in the instant case-

(a) The accountant is receiving cash and also passing the entries in the books. The accountant should not have been allowed to effect recoveries.

(b) It also appears that system for issuing receipts for amount received - whether cash or cheque is also lacking.

(c) In a small and to some extent medium size organization, the supervision of the owner offsets the deficiencies in internal control system. But in this case, it appears, that supervision and personal control is also lacking. **(3 Marks)**

Thus, in the given case, the main weakness of the system is that it is ignoring the basic requirements of a good internal control system. **(1 Mark)**

Q.4.(b) Audit Risk :

<u>Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated.</u> **(1 Mark)**

There are three components of audit risk:

(i) **Inherent risk:** The susceptibility of the subject matter information to a material misstatement, assuming that there are no related internal controls; **(1 Mark)**

(ii) **Control risk:** The risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by entity's internal controls. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements; **(2 Marks)**

(iii) **Detection risk:** The risk that the practitioner will not detect a material misstatement that exists. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. **(2 Marks)**

Ans.5. Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year. **(1 Mark)**

(ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges. **(1 Mark)**

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank. **(1 Mark)**

(iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened. **(1 Mark)**

(v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.