SUGGESTED SOLUTION

IPCC NOVEMBER 2016 EXAM

AUDIT

Test Code - I N J1 1 3 2

BRANCH - (MULTIPLE)(Date : 13.10.2016)

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Answer-1 (a) :
SA 550 on “Related Parties” casts duty on auditor to obtain sufficient appropriate audit evidence regarding the identication and disclosure by management or related parties and the related party transactions that are material to the financial statement. **(1.5 Marks)**

In the present case, the transaction with the huge purchases from other entity of same management is prima facie, prejudicial to the interest of ABC Ltd. Auditor in this case, should perform additional extended audit procedures to confirm the adequacy of correctness and disclosure of related party transactions by the management. Auditor should demand management representation regarding the adequate disclosure of the same. **(1.5 Marks)**

If the management fails to disclose the related party transactions, the auditor should express qualified opinion or disclaimer of opinion in the audit report, as appropriate **(1 Mark)**

Answer-1 (b) :
As per SA 240 on “The Auditor’s 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: **(2 Marks)**

(1) 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; **(1 Mark)**

(2) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and **(1 Mark)**

(3) If the auditor withdraws:
   - (i) 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 **(1 Mark)**
   - (ii) 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. **(1 Mark)**

Answer-1 (c) :
As per SA 330 on “The Auditor’s Responses to Assessed Risks”, changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. **(0.5 Mark)**

The auditor’s decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment. Factors that may warrant a re>test of controls are : **(0.5 Mark)**

(i) A deficient control environment. **(0.5 Mark)**
(ii) Deficient monitoring of controls. **(0.5 Mark)**
(iii) A significant manual element to the relevant controls. **(0.5 Mark)**
(iv) Personnel changes that significantly affect the application of the control. **(0.5 Mark)**
(v) Changing circumstances that indicate the need for changes in the control. **(0.5 Mark)**
(vi) Deficient general IT controls. **(0.5 Mark)**

Answer-1 (d) :
According to SA720 other information refers to Financial information (other than the financial statements and the auditor‘s report thereon) which is included, either by law, regulation or custom, in a document containing audited final statements and the auditor’s report thereon. **(2 Marks)**

The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor‘s report thereon include other information that could undermine the credibility of those statements and the auditor’s report. **(2 Marks)**

The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of auditor’s report. If it is not possible to obtain all the other prior to the date of auditor’s report, the auditor shall read such other information as soon as practicable. If, on reading the other information. the auditor shall determine whether the audited financial statements or the other information needs to be revised. **(2 Marks)**

Answer-2 (a) :
Audit Programme: An audit programme is a detailed plan of applying the audit procedure inthe given circumstances with instructions for the appropriate techniques to be adopted foraccomplishing the audit objectives.It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. **(1 Mark)**

Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work.

On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. **(0.5 Mark)**

There should be periodic review of the audit programme to assess whether the samecontinues to be adequate for obtaining requisite knowledge and evidence about the transactions. **(0.5 Mark)**

For the purpose of framing an audit programme the following points should be kept in view:

i. Audit objective
ii. Audit procedure to be applied
iii. Extent of check
iv. Timing of check
v. Allocation of work amongst the team members
vi. Special instructions based on past experience of the auditee **(2 Marks)**

Answer-2 (b) :
Comment on Matters Contained under Section 143(1) of the Companies Act, 2013:

i) Section 143(1) of the Act deals with duties of an auditors requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. **(2 Marks)**

ii) Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. **(1 Mark)**

iii) If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in nonreporting on the matters specified in Section 143(1). **(1 Mark)**

Answer-2 (c) :
Auditor’s Attendance at Annual General Meeting:

i) As per Section 146 of the Companies Act, 2013, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted. **(2 Marks)**

ii) In the instant case, the Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered. **(1 Mark)**

iii) In view of above discussed provisions of section 146, the statutory auditor of the company should attend the general meetings either through himself or through his authorised representative. **(1 Mark)**

Answer-2 (d) :

Ownership and custody of working papers:

i) As per SA-230 "Audit Documentation", the working papers are the property of the auditor, the auditor may, at his discretion make portion of or extracts from his working papers available to the client. **(1 Mark)**

ii) In the instant case the managing director of the company has demanded copies of the working papers from the auditor. **(1 Mark)**

iii) He has no right to obtain copies of the working papers from the auditor because they are the property of the auditor. However the auditor may at his discretion make portions of or extracts from the working paper to the managing director of PQR Company Ltd. **(1 Mark)**

iv) Conclusion: The auditor is not bound to oblige the managing director by supplying copies of the audit working papers. **(1 Mark)**

Answer-3 (a) :

This is a type of revenue expenditure, whose benefit extends to more than one accounting year during which it is actually incurred. Accountancy principles require that only that part of the expenditure which is pertaining to the accounting period should be debited to the profit and loss account of the year. **(1 Mark)**

Remaining amount should be carried forward in the balance sheet and it should be written off against the future income, depending upon the number of years during which the benefit of expenditures is likely to be enjoyed. This type of expenditure is known as deferred revenue expenditure. **(1 Mark)**

Part of such revenue expenditure is to be treated as assets for the purpose of disclosure in the balance sheet for the time till the benefit of such expenditure is fully exhausted. **(1 Mark)**

Some examples of deferred revenue expenditure are expenditure on an advertisement campaign to launch a product in the market, discount allowed on subscription to debentures, development expenses in the case of mines and plantations, etc. While verifying deferred revenue expenditure, this may satisfy himself that: **(0.5 Mark)**

(a) it is proper to defer the expenditure; **(0.5 Mark)**

(b) the period of amortisation of the expenditure is reasonable; **(0.5 Mark)**

(c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral; **(0.5 Mark)**

(d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue / other benefits related to the expenditure continue to exceed the amount of unamortized expenditure. **(1 Mark)**

Answer-3 (b) :

Premium paid for insurance of a motor car: Vouch from the following:

(i) Insurance cover note issued by the insurance company verifying the car no. and period of insurance coverage. **(2 Marks)**

(ii) Verify that no claim bonus is given – where entitled – by the insurance company. **(1 Mark)**

(iii) Ensure that proper adjustment is made for pre-paid insurance premium. **(1 Mark)**

Answer-3 (c) :

Analytical Review:

i) SA 500 on Audit Evidence defines analytical review as those tests of details which consists of studying significant ratios and trends and investigating unusual fluctuation and items. Thus, analytical reviews are substantive audit procedure with the help of which auditor can perform tests of details in more efficient and effective manner. **(1 Mark)**

ii) Therefore, analytical reviews are nothing best analytical review procedures which have been considered at length in SA 520 on "Analytical Procedures". **(0.5 Mark)**

iii) According to SA 520, analytical procedures include the consideration of comparisons of the entity's financial information with, for example, comparable information for prior periods or anticipated results of the entity, such as budgets or forecasts. **(1 Mark)**

iv) Consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages, between financial information and relevant non-financial information, such as payroll costs to number of employees also constitute analytical review procedures. **(1 Mark)**

v) Analytical review procedures are used for the following purposes: (a) to assist the auditor in planning the nature, timing and extent of other audit procedures; (b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and (c) as an overall review of the financial statements in the final review stage of the audit. **(2 Marks)**

vi) The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, assessment of inherent and control risks, etc. **(0.5 Mark)**

Answer-4 (a) :

Professional judgment means a judgment taken by the auditor out of his professional experience in an audit situation. According to SA 200, Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about: **(2 Marks)**

o) Materiality and audit risk; **(0.5 Mark)**
o) The nature, timing, and extent of audit procedures; **(0.5 Mark)**
o) Evaluating whether appropriate audit evidence has been obtained; **(0.5 Mark)**
o) The evaluation of management judgments in applying the entity's applicable financial reporting framework; **(0.5 Mark)**

It is required that auditors professional Judgment should be reasonable and rational. Consultation on difficult or controversial matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, assist the auditor in making informed and reasonable judgments. Further the auditor is required to prepare audit documentation relating to such reasonable professional judgments. **(2 Marks)**

Answer-4 (b) :

1. The auditor shall communicate in writing with those charged with governance when, in the auditor's professional judgment, oral communication would not be adequate. where matters required by this SA to be communicated are communicated orally, the auditor shall document them, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. **(2 Marks)**
2. The auditor shall communicate with those charged with governance on a timely basis. **(1 Mark)**
3. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. Inadequacy may lead auditor to suspicion about existence of misstatement. **(1 Mark)**

Answer-4 (c) :

Indications of Doubtful and Uncollectible Debts:

The term 'book debts' suggests particularly amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head. **(1 Mark)**

The following are some of the indications of doubtful and uncollectible debts, loans and advances:

(i) The terms of credit have been repeatedly ignored. **(0.5 Mark)**

(ii) There is stagnation or lack of healthy turnover in the account. **(0.5 Mark)**

(iii) Payments are being received but the balance is continuously increasing. **(0.5 Mark)**

(iv) Payments though being received regularly, are quite small in relation to the total outstanding balance. **(0.5 Mark)**

(v) An old bill has been partly paid (or not paid), while later bills have been fully settled. **(0.5 Mark)**

(vi) The cheques received from the trade receivables have been repeatedly dishonoured. **(0.5 Mark)**

(vii) The debt is under litigation, arbitration, or dispute. **(0.5 Mark)**

(viii) The auditor becomes aware of unwillingness or inability of the trade receivable to pay the dues, e.g., a trade receivable has either become insolvent, or has closed down his business, or is not traceable. **(0.5 Mark)**

(ix) Amounts due from employees, which have not been repaid on termination of employment. **(0.5 Mark)**

(x) Collection is barred by statute of limitation. **(0.5 Mark)**

Answer-5 (a) :

Director's Responsibility Statement:

According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. However, the provisions related to Director's Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

(i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures; **(1 Mark)**

(ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period; **(1 Mark)**

(iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities; **(1 Mark)**

(iv) the directors had prepared the annual accounts on a going concern basis; **(1 Mark)**

(v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively. Here, the term "internal financial controls" means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information; and **(1 Mark)**

(vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively. **(1 Mark)**

Answer-5 (b) :

(i) According to Section 148 of the Companies Act, 2013 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies. **(1 Mark)**

(ii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown under current assets in the balance sheet as per Schedule III Part I requirement. **(1 Mark)**

(iii) As such, the profits and current assets are understated and true and fair views of the accounts are thus vitiated. **(1 Mark)**

(iv) On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report. **(1 Mark)**

Answer-5 (c) :

In case of a recurring audit, the auditor may decide not to send a newengagement letter each period. However, the following factors may make it appropriate tosend a new letter: **(0.5 Mark)**

Any indication that the client misunderstands the objective and scope of the audit.

- Any revised or special terms of the engagement.
- A recent change in senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements or pronouncements of the Institute of Chartered Accountants of India,or changes in the existing ones. **(4 Marks)**

Therefore, in instant case since there is significant change in senior management and ownership of the company, ABC & Co should send the new letter of engagement to Alfa Ltd for the period of such change **(1.5 Mark)**

Answer-6 (a) :

By evidence we mean the material, documentary or otherwise, available to prove or disprovethe assertions made in the statement of accounts through the entries in the books of account.For example sales isevidenced by:

(i) invoices raised by the client;
(ii) price list;
(iii) forwarding notes to client;
(iv) inventory-issue records;
(v) sales managers' advice to the inventory section;
(vi) acknowledgements of the receipt of goods by the customers, and
(vii) collection of money against sales by the client.

(4 Marks)

Answer-6 (b) :

Selection of Audit Sample: Audit Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population. **(1 Mark)**

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.**(1 Mark)**

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample. **(1 Mark)**

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias. **(1 Mark)**

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

Answer-6 (c) :

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 ofconfidence of intended users in the financial statements. This is achieved by theexpression of an opinion by the auditor on whether the financial statements areprepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinionis on whether the financial statements are presented fairly, in all material respects,or give a true and fair view in accordance with the framework. An audit conducted inaccordance with SAs and relevant ethical requirements enables the auditor toformthat opinion.

(4 Marks)

Answer-6 (d) :

Advantages of having the accounts audited by an independent auditor are:-

(i) It safeguards the financial interest of persons not associated with the management like partners or shareholders.

(ii) It acts as a moral check on the employees from committing fraud.

(iii) It is helpful in settling tax liability, negotiations for loans and for determining purchase consideration for sale/merger.

(iv) It is also helpful in settling trade or labour disputes for higher wages/bonus.

(v) It helps in detection and minimizing wastages and losses.

(vi) It ensures maintenance of adequate books and records, statutory register etc.

(4 Marks)

Answer-7 (a) :

General Considerations in Company Audit : **(2 Marks)**

These have to be determined on a consideration of:

(1) objectives of audit;

(2) various provisions in the Companies Act, 2013, especially those concerning accounts and audit; and

(3) the scope of the report that the auditor of a company is required to make in pursuance of the provisions contained in section 143 of the Act.

Objectives of an Audit : **(2 Marks)**

(i) Verification of statements of account so as to express an opinion;

(ii) Detection of errors and frauds; and

(iii) Prevention of occurrence of errors and frauds.

Answer-7 (b) :

(a) The examination of records and documents is one of the most important techniques through which an auditor collects evidence. Therefore, in case the records and documents maintained by an enterprise are incomplete, it would prove to be a great handicap to the auditor. **(0.5 Mark)**

(b) An auditor may face the situation of incomplete records under the following circumstances: (i) Where records are kept on single entry basis; or (ii) Where records are kept on double entry basis, but some of the records are destroyed accidentally, or are seized by authorities, or are otherwise not available for the auditor's examination due to similar reasons. **(0.5 Mark)**

(c) Under the second circumstance, an ideal approach for carrying out audit would be that the auditor may direct the management of the enterprise to complete or reconstruct the accounting records, e.g., if vouchers are available but the cash book, journal and the ledger are not maintained, then the cash book, journal and ledger should be written up. However, if vouchers are also not available, then cash book/journal/ledger will have to be prepared by correlating the evidence available, e.g., memoranda records, bank statements, statements from outside parties, etc. Even though such books which are prepared may not be complete, but may still contain useful information for the auditor. **(0.5 Mark)**

(d) On the other hand, when books are maintained on single entry basis, then the management of the enterprise would be asked to write up the books, to the extent possible, as they would have been written up under double entry system. **(0.5 Mark)**

(e) In any case, the following steps would be required to conduct an audit: (i) Ascertain that the balance sheet or statement of affairs as at the beginning of the year should be prepared and all the relevant accounts should be opened in the ledger. Normally, under the single entry system, cash, bank, and personal accounts are maintained. (ii) Confirming that all entries on receipt side of the cash book are posted in the ledger, even by opening new account(s) wherever necessary. (iii) Check that all entries on the payment side of cash book are posted in the ledger. (iv) Confirming that all entries appearing in bank account are posted in the ledger. (v) Analyse personal accounts of trade receivables. This will provide vital information regarding credit sales, sales returns, discounts allowed, bills received, bills dishonoured, etc. It would be necessary to post such items to relevant accounts, to complete the double entry from the debtor's accounts. **(2 Marks)**

(f) Similarly, it would be necessary to analyse the trade payables' accounts and post entries relating to credit purchase made, discounts earned, purchases returns, bills payable issued to suppliers, bills payable dishonoured, etc., to relevant accounts. **(1 Mark)**

(g) From an auditor's view point, the supervisory controls exercised by the owners are generally less reliable and hence while auditing incomplete records, auditor will largely depend on extensive substantive procedures and obtain external evidence, physical examination/ observation, management representation and perform analytical procedures. **(1 Mark)**

Answer-7 (c) :

Audit Risk :

Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. **(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)**