SUGGESTED SOLUTION

IPCC May 2017 EXAM

AUDIT

Test Code - I N J1 1 6 3

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Answer-1 :

(a) **Identification of significant related party transaction outside business:** As per SA 550 on "Related Parties", for identified significant related party transactions outside theentity's normal course of business, the auditor shall:

(i) Inspect the underlying contracts or agreements, if any, and evaluate whether:

1. The business rationale (or lack thereof) the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or toconceal misappropriation of assets;
2. The terms of the transactions are consistent with management's explanations;and
3. The transactions have been appropriately accounted for and disclosed inaccordance with the applicable financial reporting framework; and

(ii) Obtain audit evidence that the transactions have been appropriately authorized andapproved.

(5 Marks)

(b) **Audit Sampling:** As per SA 530 on "Audit Sampling" the meaning of the term "AuditSampling" is the application of audit procedures to less than 100% of items within apopulation of audit evidence such that all sampling units have a chance of selection in order to provide the auditors with a reasonable basis on which to draw conclusions aboutthe entire population.

According to the said SA, requirements relating to sample design, sample size andselection of items for testing are explained below:

Sample design – When designing an audit sample, the auditor shall consider thepurpose of the audit procedure and the characteristics of the population from which thesample will be drawn.

Sample size – The auditor shall determine a sample size sufficient to reduce samplingrisk to an acceptably low level.

Selection of items for testing – The auditor shall select items for the sample in such away that each sampling unit in the population has a chance of selection.

(5 Marks)

(c) **The role of Audit Programme in audit plan and performance:** The audit programme ishelpful both in planning and performance stages of audit as follows:

(i) The audit programme lists down areas of audit before commencement.

(ii) The audit timing is built therein; thereby it becomes a schedule of audit plan.

(iii) The staff that is entrusted with the audit assignment is also specified. It is a plan of resources allocation of the firm.

(iv) It specifies the procedures to be checked during the audit.

(v) As the audit work is split into various elements of procedures to be performed, theaudit programme acts as a guiding chart or check list during the performance ofaudit.

(vi) Since the staff in charge of each work is specified and they sign the programme, itextracts the responsibility from the audit assistants.

(vii) The working papers of the audit staff can be reviewed against the audit programmewhich helps a base of reference for evaluation of the performance before reportingon the financial statements.

(viii) It also helps in preparing a diary of the performance and plan also base for billingthe clients for the time manpower involved in the audit.

(5 Marks)

(d) **Risks related to internal control in IT environment:** The specific risks related tointernal control in an IT environment includes the following:

(i) Reliance on systems or programs that are inaccurately processing data, processinginaccurate data, or both.

(ii) Unauthorized access to data that may result in destruction of data or improperchanges to data, including the recording of unauthorized or non-existenttransactions, or inaccurate recording of transactions. Particular risks may arisewhere multiple users access a common database.

(iii) The possibility of IT personnel gaining access privileges beyond those necessary toperform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorized changes to data in master files.

(v) Unauthorized changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs.

(vii) Inappropriate manual intervention.

(viii) Potential loss of data or inability to access data as required.

(5 Marks)

Answer-2 :

(a) **Correct.** The scope of work of an internal auditor may extend even beyond the financial accounting and may include cost investigation, inquiries relating to losses and wastages,production audit, performance audit, etc. **(2 Marks)**

(b) **Incorrect.** Companies Act, 2013 requires the company auditor to go beyond thefunctions of reporting and express an opinion about the propriety or prudence of certaintransactions. Also, the auditor shall remain alert throughout the audit for audit evidenceof events or conditions that may cast significant doubt on the entity's ability to continueas a going concern. Therefore it would not be correct to say that an auditor has nothingto do with prudence or profitability of a company because it may impact the goingconcern. **(2 Marks)**

(c) **Correct.** Evaluating responses to inquiries is an integral part of the inquiry process.Responses to inquiries may provide the auditor with information not previouslypossessed or with corroborative audit evidence. Alternatively, responses might provideinformation that differs significantly from other information that the auditor has obtained.In some cases, responses to inquiries provide a basis for the auditor to modify or performadditional audit procedures. **(2 Marks)**

(d) **Correct.** The questionnaire form provides an orderly means of disclosing control defects.It is the general practice to review the internal control system annually and record thereview in detail. In the questionnaire, generally questions are so framed that a 'Yes'answer denotes satisfactory position and a 'No' answer suggests weakness. **(2 Marks)**

(e) **Correct.** In cluster sampling population is divided into group called cluster and a numberof cluster is selected on random basis. In case of random sampling, each item israndomly chosen and so every item has an equal chance of being selected. Thus, clustersampling is less effective. **(2 Marks)**

(f) **Incorrect.** Error of duplication is another type of error of commission which meansrecording the same transaction twice. Therefore, this error will not affect the trial balance. **(2 Marks)**

(g) **Incorrect.** Substantive procedure is an audit procedure designed to detect materialmisstatements at the assertion level. It comprise (i) tests of details (of classes oftransactions, account balances, and disclosures), and (ii) substantive analyticalprocedures. **(2 Marks)**

(h) **Incorrect.** As per section 139(7) of the Companies Act, 2013, in the case of aGovernment company, the first auditor shall be appointed by the Comptroller andAuditor-General of India within 60 days from the date of registration of the company. Alternatively, the statement would be correct in case C&AG does not appoint the firstauditor within 60 days, Board of Directors of the company shall appoint the first auditorwithin next 30 days. **(2 Marks)**

(i) **Incorrect.** As per the provisions of the Companies Act, 2013, it is no part of the auditor'sduty to send a copy of his report to members of the company. The auditor's dutyconcludes once he forwards his report to the company. It is the responsibility of companyto send the report to every member of the company.

(2 Marks)

(j) **Correct.** A Chartered Accountant appointed as an auditor of a company, should ensurethe independence in respect of his appointment. In this case, Mr. Pawan is a “TaxConsultant” and not a “Statutory Auditor” or “Tax Auditor” of ABC Ltd., hence he is notsubject to the above requirements.

(2 Marks)

Answer-3 :

(a) Preliminary Expenses:

(i) Check Board’s minutes book containing the resolution approving the expensesclaimed by promoters as having been spent in formation of the company.

(ii) Examine supporting papers and vouchers, contracts, agreements, etc. to supportthe promoters’ claims. Also check bills and receipts issued by the printer of thememorandum and articles of association, share certificates, etc.

(iii) Check receipt for the registration fee paid for registration of the company.

(iv) Verify rates of stamp required to be affixed on the memorandum and articles of association.

(v) Examine the compliance of AS 26 with regard to treatment of such preliminary expenses in the books of account i.e. Expenditure in connection with the preliminaryexpenses should be treated as an expense in the year of incurring and not to be carry forward for writing off in future years.

(vi) Check that no expenses other than those constitute preliminary expenses are booked under this head, e.g. underwriting commission and brokerage paid.

(vii) The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance-sheet. Any amount paid inexcess of the amount disclosed in prospectus should have been approved by theshareholders.

(4 Marks)

(b) Customs & Excise Duties

Custom Duty:

(i) Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.

(ii) If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent’s bill.

(iii) If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.

(iv) Make a list of disputed cases to have knowledge of the amount of duty payable and the provisional payment. The auditor should determine the duty payable and ensureany additional duty to be paid or refund expected should have been adjusted.

(v) The auditor should also verify the duty drawback.

Excise Duty:

(i) Ensure that excise duty is paid at the time of issue of excisable goods from the godown at factory of the producer. The duplicate copy of the challan as issued bythe bank is forwarded for the purpose of issue of the excisable goods.

(ii) Verify the amount of duty paid with the corresponding value of the goods issuedfrom the inventory register of the producer by applying test check. In case where theclient maintains an advance deposit with Excise Department, the auditor should seethat the permits are issued for delivery of the goods against the advance depositand corresponding adjustment.

(iii) Ascertain the rates of excise duty and apply it to the total sales and see that theamount actually paid does not exceed the amount thus calculated.

(iv) Ascertain that in case of dispute about the amount of duty payable, a provisionalamount may be paid in lieu of final amount. In such cases, the final amountdetermined as payable should be verified. If the provisional payment was more thanthe actual amount, the refund of such excess amount should be vouched.

(v) The auditor may also physically verify requisite registers maintained with actual andsee reconciliation of financial records with sales tax records.

(4 Marks)

(c) **Floating Assets:** Floating assets are acquired for resale with a view to earning profits orare those that come into existence during the processes of trade or manufacture. Allthose, in the normal course of business, are quickly convertible into cash, e.g., inventory,trade receivable, bills receivable, etc.

The auditor is required to verify the floating assets by:

(i) Examination of records;

(ii) Attendance at inventory-taking;

(iii) Obtaining confirmations from third parties;

(iv) Examination of valuation and disclosure;

(v) Analytical review procedures.

(4 Marks)

(d) **Recovery of bad debts written off:**

(i) Verify the relevant correspondence with the trade receivable whose accounts were written off as bad.

(ii) See that the amount recovered is credited to a separate account recovery of bad debts written off.

(iii) Verify the acknowledgement receipt issued to debtors.

(iv) Examine notification from the court, bankruptcy trustee and all correspondence fromdebtors and collecting agencies.

(v) Check credit manager's file for the amount received and see that the amount hasbeen deposited in the bank promptly.

(vi) Review the internal control system regarding writing off and recovery of bad debts.

(4 Marks)

Answer-4 :

(a) **Disclosure requirements of current investment:** In Schedule III Part I of the Companies Act, 2013, Current Investments are shown under the head Current Assets.Further, Schedule III requires that company shall disclose "Current Investments" in notesto accounts as follows-

(i) Current Investments shall be classified as:

(a) Investments in equity instruments;

(b) Investments in preference shares;

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investment in mutual funds;

(f) Investments in partnership firms;

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate (indicating separately whether bodies are subsidiaries, associates, joint ventures orcontrolled special purpose entities) in whom investments have been made and thenature and extent of the investment so made in each such body corporate (showingseparately investments which are partly paid). In regards to investments in thecapital of partnership firms, the names of the firms (with the names of all theirpartners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments.

(b) Aggregate amount of quoted investments and market value thereof.

(c) Aggregate amount of unquoted investments.

(d) Aggregate provision made for diminution in value of investments. **(6 Marks)**

(b) Significant matters to be recorded in Audit Note Book: Significant matters observedduring the course of audit, a record of which should be kept in the Audit Note Book areas follows:

(i) Audit queries not cleared immediately e.g. missing receipts, vouchers, etc.

(ii) The mistakes or irregularities observed during the course of audit e.g. cases of failure to comply with the requirements of the Companies Act, 2013 or theprovisions contained in the Memorandum or articles, a chance in the basis ofvaluation of finished inventory and work-in-progress or in computation ofdepreciation; failure to provide adequate depreciation, etc.

(iii) Unsatisfactory book-keeping arrangements, costing method, internal or financialadministration or organization.

(iv) Important information about the company which is not apparent from the accounts.

(v) Special points requiring consideration at the time of verification of final accounts.

(vi) Important matters for future reference. **(6 Marks)**

(c) Use of flow chart in evaluation of internal control: Flow chart is a graphicpresentation of each part of the company's system of internal control. It is considered to be the most concise way of recording the auditor's review of the system. It minimizes theamount of narrative explanation and thereby achieves a consideration or presentation notpossible in other form. It gives bird's eye view of the system and flow of transaction andintegration and in documentation, can be easily spotted and improvement can besuggested.

It is also necessary for the auditor to study the significant features of the business carriedon by the concern; the nature of its activities and various channels of goods andmaterials as well as cash, both inward and outward; and also a comprehensive study ofthe entire process of manufacturing, trading and administration. This will help himunderstand and evaluate the internal controls in the correct perspective. **(4 Marks)**

Answer-5 :

(a) Audit of books of accounts of Partnership Firm: Matters which should be speciallyconsidered in the audit of accounts of a partnership firm are as under -

(i) Confirming that the letter of appointment, signed by a partner, duly authorized,clearly states the nature and scope of audit contemplated by the partners, speciallythe limitation, if any, under which the auditor shall have to function.

(ii) Examine the partnership deed signed by all partners and its registration with theregistrar of firms. Also ascertain from the partnership deed about capital contribution,profit sharing ratios, interest on capital contribution, powers and responsibilities of thepartners, etc.

(iii) Studying the minute book, if any, maintained to record the policy decision taken bypartners specially the minutes relating to authorization of extra ordinary and capitalexpenditure, raising of loans, purchase of assets, extraordinary contracts enteredinto and other such matters as are not of a routine nature.

(iv) Verifying that the business in which the partnership is engaged is authorized by thepartnership agreement; or by any extension or modification thereof agreed tosubsequently.

(v) Examining whether books of account appear to be reasonable and are consideredadequate in relation to the nature of the business of the partnership.

(vi) Verifying generally that the interest of no partner has suffered prejudicially by anactivity engaged in by any violation of a provision in the partnership agreements.

(vii) Confirming that a provision for the firm's tax payable by the partnership has beenmade in the accounts before arriving at the amount of profit divisible among thepartners.

(viii) Verifying that the profits and losses have been divided among the partners in theiragreed profit sharing ratio.

(6 Marks)

(b) Audit Programme of a Local Body

(i) The Local Fund Wing of the State Government is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbaietc. have power to appoint their own auditors for regular external audit. So, theauditor should ensure his appointment.

(ii) The auditor while auditing the local bodies should report on the fairness of thecontents and presentation of financial statements, the strengths and weaknesses ofsystem of financial control, the adherence to legal and/or administrativerequirements; whether value is being fully received on money spent. His objectiveshould be to detect errors and fraud and misuse of resources.

(iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulationsframed by the competent authority.

(iv) He should ensure that all types of sanctions, either special or general, are accordedby the competent authority.

(v) He should ensure that there is a provision of funds and the expenditure is incurredfrom the provision and the same has been authorized by the competent authority.

(vi) The auditor should check that the different scheme, programmes and projects,where large financial expenditure has been incurred, are running economically andgetting the expected results.

(6 Marks)

(c) Precautions to be taken while applying test check technique: The precautions to betaken while adopting test check technique are following-

(i) The transactions of the concern should be classified under appropriate heads andmay be stratified if wide variations are there between transactions of the same kind.

(ii) Authorisations, documentations, recording of the transactions should be studiedright from the beginning to end.

(iii) Evaluating the system of internal control for its efficiency, soundness and capabilityto produce reliable accounting and financial data.

(iv) Preparation of test check plan with clear audit objective understood by the auditstaff.

(v) Un-biased selection of the transactions with reference to the random number tablesor other statistical methods.

(vi) Identification of the areas where test check may not be done.

(vii) Based on degree of reliance and the confidence level required in the audit, thenumber of transactions to be selected for each test plan should be pre-determined.

(viii) Setting up criteria to judge what constitute material or immaterial errors. Furtherinvestigation of only material errors be carried out and all immaterial errors may beavoided.

(4 Marks)

Answer-6 :

(a) **Matters to be included in Director's Responsibility Statement:** The provisions relatedto the Director's responsibility under section 134(5) of the Companies Act, 2013 are asunder:

(i) In the preparation of the annual accounts, the applicable accounting standards hadbeen followed along with proper explanation relating to material departures;

(ii) The directors had selected such accounting policies and applied them consistentlyand made adjustments and estimates that are reasonable and prudent so as to givea true and fair view of the state of affairs of the company at the end of the financialyear and of the profit and loss of the company for that period;

(iii) The directors had taken proper and sufficient care for the maintenance of adequateaccounting records in accordance with the provisions of this act for safeguarding theassets of the company and for preventing and detecting frauds and otherirregularities;

(iv) The directors had prepared the annual accounts on a going concern basis;

(v) The directors, in the case of a listed company, had laid down internal financialcontrols to be followed by the company and that such internal financial controls areadequate and were operating effectively;

(vi) The directors had devised proper system to ensure compliance with the provisionsof all applicable laws and that such systems were adequate and operatingeffectively.

(6 Marks)

(b) **Authentication of Financial Statements:** Section 134(1) of the Companies Act, 2013 provides that the financial statements, including consolidated financialstatement, if any, shall be approved by the board of directors before they are signed onbehalf of the board at least by the following:

(i) chairperson of the company where he is authorized by the Board; or

(ii) By two directors out of which one shall be managing director and the Chief Executive Officer, if he is a director in the company,

(iii) The Chief Financial Officer and the company secretary of the company, wherever they are appointed.

However, in the case of a one person company, the financial statement shall be signed by only one director, for submission to the auditor for his report thereon.

According to section 134(7) of the Companies Act, 2013, a signed copy of every financial statement, including consolidated financial statement, if any, shall beissued, circulated or published along with a copy each of

(i) Any notes annexed to or forming part of such financial statement;

(ii) The auditor's report; and

(iii) The Board's report

(6 Marks)

(c) **Validity of any transaction:** For checking the validity of a transaction, it is usuallynecessary to refer to documentary evidence. It may exist in any of the following forms-

(i) The legal provisions, if any, having bearing on the accounts of the entity under audit.

(ii) The rules or regulations governing the internal working of the organization, e.g., theArticles of Association, Partnership Deed, Trust Deed, etc.

(iii) Minutes of the proceedings of a meeting of members of the company, that of thedirectors or that of the Managing committee.

(iv) Copy of an agreement, e.g., Managing Director's agreement, Lease Deed, vendor'sagreement, agency agreement, contract with an employee, etc.

(v) Well recognized accounting principles and practices e.g., distinction between capitaland revenue, accrual system of accounting, valuation principles etc.

An auditor should have a clear and precise knowledge of legal provisions under whichthe concern was registered or is functioning, as well as those which constitutes the basisof various transactions entered into, more particularly the provisions as regardsmaintenance and audit of its accounts. He should also study the rules, if any, framed forregulating the internal management of the entity; these may be embodied in some of thedocuments mentioned above. If he has any doubt on any legal point, by way of guidance,he should call for legal opinion. However, unless he is convinced of the reasonablenessof the legal opinion, he should not act on it.

(4 Marks)

Answer-7 :

(a) **Provisions for applicability of Internal Audit:** As per section 138 of the Companies Act, 2013 the following class of companies rules, shall be required to appoint an internalauditor or a firm of internal auditors namely -

(i) Every listed company;

(ii) Every unlisted public company public company having -

(a) Paid up share capital of fifty crore rupees or more during the precedingfinancial year; or

(b) Turnover of two hundred crore rupees or more during preceding financial year;or

(c) Outstanding loan or borrowing from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during thepreceding financial year; or

(d) Outstanding deposits of twenty five crore rupees or more at any point of timeduring the preceding financial year; and

(iii) Every private company having-

(a) Turnover of two hundred crore rupees or more during the preceding financial year; or

(b) Outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during thepreceding financial year.

(4 Marks)

(b) **Prohibition on buy-back of own shares:** As per provisions of section 70 of TheCompanies Act, 2013-

(i) No company shall directly or indirectly purchase its own shares or other specifiedsecurities:

(a) Through any subsidiary company including its own subsidiary companies; or

(b) Through any investment company or group of investment companies; or

(c) If a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment ofdividend to any shareholder or repayment of any term loan or interest payablethereon to any financial institution or bank, is subsisting.

Provided that the buy-back is not prohibited if the default is remedied and aperiod of 3 years has elapsed since the cessation of the default.

(ii) No company shall directly or indirectly purchase its own shares or other specifiedsecurities in case such company has not complied with the prescribed provisions ofSections.

(4 Marks)

(c) **Advantages of CAAT:** Following are the advantages of Computer Aided AuditTechniques-

(i) **Audit effectiveness:** The effectiveness and efficiency of auditing procedures will beimproved through the use of CAAT in obtaining and evaluating audit evidence, forexample.

(a) Some transaction may be tested more effectively for a similar level of cost byusing the computer and

(b) In applying analytical review procedures, transactions or balance details ofunusual items may be reviewed and reports got printed efficiently by using thecomputer.

(ii) **Saving in time:** The auditor can save time by reviewing the CIS controls usingCAAT than through other audit procedures.

(iii) **Effective test checking and examination in depth:** CAAT permits effectiveexamination in depth of selected transactions since the auditor constructs the last audit trail.

(4 Marks)

(d) **Changes in accounting policy:** A change in an accounting policy should be made only if

(i) the adoption of a different accounting policy is required by statute or

(ii) for compliance with an accounting standard or

(iii) if it is considered that the change would result in a more appropriate presentation ofthe financial statements of the enterprise.

Disclosure of change in accounting policy: Any change in an accounting policy whichhas a material effect should be disclosed. The impact of and the adjustments resultingfrom, such change, if material, should be shown in the financial statements of the periodin which such change is made, to reflect the effect of such change. Where the effect ofsuch change is not ascertainable, wholly or in part, the fact should be indicated. If achange is made in the accounting policies which has no material effect on the financialstatements for the current period but which is reasonably expected to have a materialeffect in later periods, the fact of such change should be appropriately disclosed in theperiod in which the change is adopted.

(4 Marks)

(e) **Recognition of Interest on deposits**

(i) AS - 9 on "Revenue Recognition" requires that the revenue arising from interest should be recognized on a time proportion basis taking into account the amount outstanding and the rate applicable. Such revenue should only be recognized whenno significant uncertainty as to measurability or collectability exists.

(ii) Further, according to section 128 of the Companies Act, 2013 books are to bemaintained on accrual basis. Again, accrual method of accounting is a fundamentalassumption of accounting policies.

(iii) Interest accrued but not due should be shown under current assets in the balancesheet.

(iv) If interest on deposits is not recognized on accrual basis, the profits and currentassets will be understated and true and fair views of the accounts, thus vitiated.

(v) On considerations of materiality of the item, the auditor may appropriately qualifythe report.

(4 Marks)