



J.K. SHAH[®]
TEST SERIES

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SUGGESTED ANSWERS

CA INTER

Test Code – JK-AUD-12

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

Tel: (022) 26836666

Answers

Part I – Multiple Choice Questions

- (1) (i) (a)
(ii) (b)
(iii) (c)
(iv) (d)
- (2) (a)
- (3) (a)
- (4) (a)
- (5) (a)
- (6) (b)
- (7) (b)
- (8) (b)
- (9) (d)
- (10) (a)
- (11) (d)
- (12) (a)
- (13) (b)
- (14) (d)
- (15) (c)
- (16) (d)
- (17) (b)
- (18) (c)
- (19) (b)
- (20) (b)
- (21) (d)
- (22) (b)

Part II – Descriptive Questions**Q.1****(a)**

(a) Incorrect - internal source (within the entity).

Reliability of audit evidence is increased when obtained from independent source outside the entity.

External evidence are more reliable than Internal evidence.

(b) Incorrect - The risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at Financial statement level & Assertion level

(c) Incorrect - Auditor shall report immediately but not later than 48 hours

(d) Incorrect - process of assembling the final audit file within 60 days after the date of the auditor's report.

(e) Incorrect - Application control include both automated and manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz.,

(f) Incorrect - Only the fraud that causes Material Misstatement not all the fraud.

(g) Incorrect - Auditor shall make a periodic review to check whether it continues to be effective for the audit.

(h) Incorrect - Auditor has to answer two sets of questionnaires called as audit memos.

(2 x 7 = 14 Marks)

Q.2**(a)**

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

- A request from the client for the auditor to change the engagement may result from-
- a change in circumstances affecting the need for the service,

- a misunderstanding as to the nature of an audit or related service originally requested.
- a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. **(4 Marks)**

(b)

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

- The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated
- Professional skepticism includes being alert to, for example:
 - Audit evidence that contradicts other audit evidence obtained.
 - Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
 - Conditions that may indicate possible fraud.
 - Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
 - Overlooking unusual circumstances.
 - Over generalizing when drawing conclusions from audit observations.
 - Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

(4 Marks)**(c)**

Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised ,

- As a result of a change in circumstances that occurred during the audit (for example,
- A decision to dispose of a major part of the entity's business),

- New information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.
- Example
- If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.
- If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate,
- The auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

(3 Marks)

(d)

Relationship between the Audit plan and Overall audit strategy.

Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

- The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes,
- But are closely inter-related since changes in one may result in consequential changes to the other.

(3 Marks)

Q.3

(a)

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

stratification

Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

- The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
- When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement,
- when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
- The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.
- value-weighted
- When performing tests of details, it may be efficient to identify the sampling unit as the individual monetary units that make up the population.
- Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.
- One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.
- This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

(4 Marks)

(b)

As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company

Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance processes, risk management and internal control such as the following:



(3 Marks)

(c)

Evolving One Audit Programme – Not Practicable for All Businesses

Businesses vary in nature, size and composition;

Work which is suitable to one business may not be suitable to others;

Efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment.

On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

- However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.
- To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme.

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(d)**SUITABILITY OF PARTICULAR ANALYTICAL PROCEDURES FOR GIVEN ASSERTIONS**

The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Example

If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion

And the auditor's assessment of the risk of material misstatement.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion.

(3 Marks)**Q.4****(a)**

Right and obligation assertion of PPE

In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

- The auditor should insist and verify the original title deeds for all immovable properties held as at the balance sheet date.
- In case the entity has given such immovable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from

the respective lenders that they are holding the original title deeds of immovable property as security.

- In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties.

(4 Marks)

(b)

Rent expenses

- Obtain a month wise expense schedule along with the rent agreements. Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement. Specific consideration should be given to escalation clause in the agreement to verify if the rent was to be increased/adjusted during the period under audit. Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity.

Power and Fuel expenses

- Obtain a month wise expense schedule along with the power bills. Verify if expense has been recorded for all 12 months. Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis. In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

(4 Marks)

(c)

Ensure whether the following disclosure requirements of Ind AS compliant Schedule III to Companies Act, 2013 have been complied with:

Issued and subscribed share capital

(Number of shares and value)

Balance at the beginning of the reporting period

Changes in equity share capital during the year

Balance at the end of the reporting period

For each class of capital

Rights attached

Preferences

Restrictions, including

Restrictions on the distribution of dividends

Restrictions on the repayment of capital

Shares held in Company by the following entities:

Holding company

Ultimate holding company

Subsidiaries of the holding company

Associates of the holding company

Subsidiaries of the ultimate holding company

Associates of the ultimate holding company

Shares held in the company held by each shareholder holding more than 5% shares specifying the number of shares held

Aggregate number and class of shares for:

Allotted as fully paid up pursuant to contract(s) without payment being received in cash

Allotted as fully paid up by way of bonus shares

Bought back

Above disclosure should have been made for a period of five years immediately preceding the balance sheet date.

(3 Marks)

(d)

Definition of Key Audit Matters: Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance

Purpose

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.

- Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.
- Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

(3 Marks)

Q.5**(a)**

When the inventory held is material to the financial statements, Auditor shall obtain sufficient and appropriate audit evidence regarding the existence and conditions of the inventory by:

Attendance at physical inventory counting, unless impracticable, to:

Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

Observe the performance of management's count procedures;

Inspect the inventory; and

Perform test counts.

b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(4 Marks)

(b)

Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved.

- This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.
- Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
- While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

(4 Marks)

(c)

Other reporting responsibility under the Elements of auditors report.

If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the SAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled-

- "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the SAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the SAs.

(3 Marks)

(d)

Auditor shall design and perform audit procedure in order to identify litigation and claim involving the entity which may give a rise to risk of material misstatement by :

Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and Reviewing legal expense accounts.

(3 Marks)

Q.6

(a)

The special steps involved in such an audit are stated below-

- (1) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- (2) Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

- (3) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- (4) Check totals of various columns of the Register of members and tally them across.
- (5) See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
- (6) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
- (8) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- (9) Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
- (10) Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.
- (11) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.
- (12) Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

(any Six to Seven points)

(4 Marks)

(b)

In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertain to the bank, that there is no unrecorded

income, and that income is recorded in proper amounts and is allocated to the proper period.

- RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per AS-9.
- If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify the statements in that situation

Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.

- In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also.
- Interest on advances against Term Deposits, National Savings Certificates (NSCs), Indira Vikas Patras (IVPs), Kisan Vikas Patras (KVPs) and Life policies may be taken to income account on the due date, provided adequate margin is available in the accounts.
- In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years. [The Unexpired discount / rebate on bills discounted i.e., where part of receipt comprising discount charges on bills purchased relate to the period beyond the year-end, should be recorded as "Other Liabilities"]. Interest (discount) component paid by Bank/Branch on rediscount of bills from other financial institutions, is not to be netted off from the discount earned on bills discounted.
- In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee either by the bank itself or through its

agents, etc. This procedure is in consonance with the nature of obligations of the bank in respect of bills for collection. The commission of the branch becomes due only when the bill has been collected.

- Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit. Test checks the Interest earned by the banks for sample items.
- Test check the Fees and commissions earned by the banks made for commission on Bills for collection; Letters of credit; Bank Guarantees.

(any five to six point)

(4 Marks)

(c)

All accounts should be kept within both the drawing power and the sanctioned limit at all times. The accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the Management/Head Office regularly.

- Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.
- The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinised in detail.
- The audited Annual Report submitted by the borrower should be scrutinised properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.
- It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.
- The stock audit should be carried out by the bank for all accounts having funded exposure of more than ₹ 5 crores. Auditors can also advise for stock audit in other

cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

(any four to five point)

(3 Marks)

(d)

According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

- With the passage of time, it was felt that regularity audit alone was not sufficient to protect properly the public interest in the spending of money by the executive authorities. A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in in fructuous expenditure or a school building may be constructed but used after five years of its completion is a case of avoidable expenditure.
- Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faith fullness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit.
- Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:
- The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- Public moneys should not be utilised for the benefit of a particular person or section of the community

(3 Marks)