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SUGGESTED SOLUTION

INTERMEDIATE

SUBJECT- AUDIT

Test Code - PIN 5066

BRANCH - () (Date :)

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Division A- M.C.Q

ANSWER 1:

Q-1 to Q-10 Carries 1 Mark each.

Q-11 to Q-20 Carries 2 Marks each.

1. **D**
2. **C**
3. **A**
4. **C**
5. **A**
6. **B**
7. **A**
8. **B**
9. **D**
10. **A**
11. **C**
12. **D**
13. **C**
14. **C**
15. **C**
16. **B**
17. **D**
18. **D**
19. **D**
20. **D**

Division B- Descriptive Questions

ANSWER 1:

(a) **Incorrect:** Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

(b) **Correct:** Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records.

Thus under a properly framed programme, the danger is significantly less and the audit can proceed systematically.

(c) **Incorrect**: Entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

(d) **Incorrect:** The CARO specifically **exempts** a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees 1 crore as on the balance sheet date and which does not have total borrowings exceeding rupees 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees 10 crore during the financial year as per the financial statements.

From the above, it is clear that ABC Pvt. Ltd. is a subsidiary of XYZ Ltd. and hence not exempt from CARO, 2016 although it is satisfying the conditions that allow exemption to private limited company which is not a subsidiary or holding company of a public company

(e) **Incorrect**: As per section140(2) of the Companies Act, 2013, the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT–3(as per Rule 8 of CAAR) with the company and the Registrar.

(f) **Correct:** The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques.

(g) **Incorrect**: The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedure, is based on the audtior's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

(h) **Incorrect**: The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

ANSWER 2:

(A)

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for **<u>high risk areas</u>** or the **<u>involvement of experts</u>** on complex matters;
2. The amount of resources to allocate to **<u>specific audit areas</u>**, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
3. When these resources are to be deployed, such as whether at an **<u>interim audit</u>** stage or at **<u>key cut-off dates</u>**; and
4. How such **<u>resources are managed, directed and supervised,</u>** such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place **(for example, on-site or off-site),** and whether to complete engagement quality control reviews.

(4 marks)

(B)

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered,

- Inaccurate processing of data, processing inaccurate data, or both
- Unauthorized access to data
- Direct data changes (backend changes)
- Excessive access / Privileged access (super users)
- Lack of adequate segregation of duties
- Unauthorized changes to systems or programs
- Failure to make necessary changes to systems or programs
- Loss of data **(4 marks)**

(C)

The principal aspects to be covered in an audit concerning final statements of account are the following:

(i) **<u>An examination of the system of accounting and internal control</u>** to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

(ii) **<u>Reviewing the system and procedures</u>** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) **<u>Checking of the arithmetical accuracy of the books of account</u>** by the verification of postings, balances, etc.

(iv) **<u>Verification of the authenticity and validity of transaction</u>** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) **<u>Ascertaining that a proper distinction has been made between items of capital and of revenue nature</u>** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) **<u>Comparison of the balance sheet and profit and loss account or other statements with the underlying record</u>** in order to see that they are in accordance there with.

(vii) **<u>Verification of the title, existence and value of the assets</u>** appearing in the balance sheet.

(viii) **<u>Verification of the liabilities</u>** stated in the balance sheet.

(ix) **<u>Checking the result shown by the profit and loss</u>** and to see whether the results shown are true and fair.

(x) **<u>Where audit is of a corporate body, confirming that the statutory requirements</u>** have been complied with.

(xi) **Reporting to the appropriate person / body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organization.

(Students can write any six points among above) (6 marks)

ANSWER 3:

(A)

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate. **(4 marks)**

(B)

Permission of Central Government for Removal of Auditor Under Section 140(1) of the Companies Act, 2013: Removal of auditor before expiry of his term i.e. before he has **submitted his report is a serious matter** and may **adversely affect his independence**.

Further, in case of **conflict of interest** the shareholders may remove the auditors in their own interest.

Therefore, law has provided this **safeguard** so that central government may know the reasons for such an action and if not satisfied, may not accord approval.

On the other hand if **auditor has completed his term** i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the **permission of the Central Government is required** when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term. **(4 marks)**

(C)

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

(i) The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that the accounts have been drawn up with reference to entries in the books of account;

(ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;

(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

(iv) the information conveyed by the statements is clear and unambiguous;

(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

(6 marks)

ANSWER 4:

(A)

Special points of consideration while auditing certain transactions of a hospital are stated below-

(i) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from who man amount was recoverable according to the rules of the hospital.

(ii) **Collection of Cash**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counter foils of dividend and other interest warrants, copies of rent bills, etc.

(iii) **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(iv) **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(v) **Authorization and Sanctions**: Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorized. **(5 marks)**

(B)

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

(4 marks)

(C)

Review board minutes for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are authorized. Ensure that significant debt commitments should be approved by the board of directors

- Agree details of **<u>loans recorded</u>** (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits imposed by agreements are not exceeded.
- Agree **<u>overdrafts and loans recorded to bank confirmation</u>** / confirmation to lenders.
- Agree details of **<u>leases and hire purchase</u>** creditors recorded to underlying agreement.
- **<u>Examine trust deed</u>** for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a **<u>discharge is received on assets</u>** securing the debt.
- If we become aware of **<u>significant transactions that are outside the normal course</u>** of business or that otherwise appear to be unusual given our understanding of the entity and its environment, perform the following procedures:
  - (a) Gain an understanding of the business rationale for such significant unusual transaction.
  - (b) Consider whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity we are auditing.

(5 marks)

ANSWER 5:

(A)

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:

(i) the auditor's **<u>assessment of risk is judgmental</u>** and so may not identify all risks of material misstatement; and

(ii) there are **<u>inherent limitations to internal control</u>**, including management override.

2. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce **audit risk to an acceptably low level**. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only **tests of details** are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assesse drisks.

3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. **SA 520,** "Analytical Procedures" establishes requirements and provides **guidance on the application of analytical procedures** during an audit.
4. The nature of the risk and assertion is **relevant to the design of tests of details.** For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement **takes account of internal control**, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

(6 marks)

(B)

Applicability of Section 139(2) Rotation of Auditor: As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

(I) all **unlisted public companies** having paid up share capital of rupees **ten crore or more;**

(II) all **private limited companies** having paid up share capital of rupees **fifty crore or more;**

(III) All companies having paid up share capital of below threshold limit mentioned above, but having **public borrowings from financial institutions**, banks or public deposits of rupees **fifty cores or more**.

From the above, it can be concluded that rotational provisions would not be applicable.

(4 marks)

(C)

Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

(4 marks)

ANSWER 6:

(A)

Stratification and Value-Weighted Selection: In considering the **<u>characteristics of the population</u>** from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. **<u>SA 530</u>** provides **<u>guidance to the auditor</u>** on the use of stratification and value-weighted sampling techniques.

(1 mark)

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 **<u>objective of stratification is to reduce the variability</u>** 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, **for example, when testing the allowance for doubtful accounts in the evaluation of accounts receivable, balances may be stratified by age.**

The results of audit procedures applied to a sample of items **<u>within a stratum</u>** 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.

For **<u>example,</u>** 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the **<u>misstatement is projected for each stratum separately</u>**. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance. **(3 marks)**

Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as **<u>the individual monetary units</u>** that make up the population. Having selected specific monetary units from within the population, **<u>for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.</u>** 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. **(2 marks)**

(B)

For each component of other equity, whether the company has disclosed the following (to the extent applicable):

1. Balance at the beginning of the reporting period
2. Changes in accounting policy or prior period error
3. Restated balance at the beginning of the reporting period
4. Total comprehensive income for the year end
5. Dividends
6. Transfer to retained earnings
7. Any other change (to be specified)
8. Balance at the end of reporting period

(4 marks)

(C)

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 immoveable properties held as at the balance sheet date. In case the entity has given such immoveable 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 immoveable 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 thirdparties.

(4 marks)