WT 1 (Chapters 1 and 11)

Instructions: **Part A comprises of MCQ.**

Part B Comprises of descriptive questions.

Part – A (Multiple Choice Questions)

Q.1 (b) (2 Mark)

Q.2 (c) (2 Mark)

Q.3 (b) (1 Mark)

Q.4 (b) (1 Mark)

Q.5 (d) (1 Mark)

Part B (Descriptive Questions)

Q.1 **(a)** Statement is correct.

Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats and if partner of the firm deals with shares and securities of the audited firm then such threat is known as the Advocacy Threats and auditor will be lacking independence. **(2 Marks)**

(b) Statement is incorrect.

- Chief Advantage of audit lies in safeguarding financial interest of shareholders not management.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. F.S. are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit. **(2 Marks)**

(c) Statement is incorrect.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities. **(2 Marks)**

Q.2 (a) **Objectives of Audit**:

In conducting audit of financial statements, objectives of auditor in accordance with SA-200 "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

2 Marks

An analysis of above brings out following points clearly:

(1) Auditor's objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error.

(2) Misstatements in financial statements can occur due to fraud or error or both.

(3) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(4) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing.

Therefore, perception of both assistants is not proper. Auditor of financial statements does not seek to provide guarantee that financial statements are free from material misstatements caused by frauds or errors.

(2 Marks)

(b) **SA 220 is premised on the basis that the firm is subject to SQC 1:**

Audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is responsibility of auditor to maintain high audit quality. SQC 1 and SA 220 both deal with quality control. SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.

(0.5 Marks)

Based upon quality control system of firm established in accordance with requirements of SQC 1, quality control policies pertaining to audit engagements are decided by engagement teams. Engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220. **(1 Mark)**

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement. **(0.5 Marks)**

Q.3 (a) **Standards on Auditing and Standards on Review Engagements:**

- "Audit" and "Review" are two different terms. Audit is a reasonable assurance engagement and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, "review" is a limited assurance engagement and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement. **(1 Mark)**
- Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit

sampling, going concern and forming an opinion and reporting on financial statements. Some examples of Standards on Auditing are:

(i) SA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing.

(ii) SA 230: Audit Documentation.

(iii) SA 315: Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment.

(iv) SA 500: Audit Evidence.

(v) SA 700: Forming an Opinion and Reporting on Financial Statements. **(1 Mark – any 2 Points)**

(a) Examples of Standards on Review engagements are:

(i) SRE 2400: Engagements to Review Historical Financial Statements.

(ii) SRE 2410: Review of Interim Financial Information Performed by the Independent Auditor of the Entity. **(1 Mark)**

(b) **Responsibility to detect material misstatements in financial statements:**

SA 210 deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those with governance, are present.

The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

(A) Establishing whether the preconditions for an audit are present and

(B) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement. **(1 Mark)**

One of the preconditions for an audit is to obtain the agreement of management that it acknowledges and understands its responsibility for preparation of financial statements and for such internal control as is necessary to enable preparation of financial statements that are free from material misstatements.

In the given situation, CA X is insisting only upon obtaining agreement of management regarding acknowledgment of its responsibility for internal control to enable preparation of financial statements that are free from material misstatements in accordance with SA 210. Design, implementation and maintenance of internal control to ensure preparation of reliable financial statements that are free from material misstatements is management's responsibility. He is insisting on obtaining agreement of management regarding acknowledgment of its responsibility. Therefore, CA X's view is proper. **(1 Mark)**

In case management does not provide such agreement acknowledging its responsibility, the auditor shall not accept proposed audit engagement unless required by law or regulation. **(1 Mark)**

Q.4 (a) **The Nature of Audit Procedures:**

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is possibility that **management or others may not provide, intentionally or unintentionally, the complete information** that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor. **(1 Mark)**
2. Fraud may involve **sophisticated and carefully organised schemes designed to conceal it**. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents. **(1 Mark)**
3. An **audit is not an official investigation into alleged wrongdoing**. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation. **(1 Mark)**

(b) **Professional Skepticism**:

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism includes being alert to, for example:

(1) Audit evidence that contradicts other audit evidence obtained.

(2) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

(3) Conditions that may indicate possible fraud.

(4) Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

(5) Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalising 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.

1 Mark for each Correct Point – Any Three