

Suggested Answers and Marking Scheme

MTP 1 (Ch. 1 and 11)

Marks: 27

Time: 50 Minutes

Instructions: Part A comprises of MCQ.

Part B Comprises of descriptive questions.

Part – A (Multiple Choice Questions)

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| Q.1 | (a) | Engagement quality control review is mandatory in such type of engagement. It was not proper to bypass such review. He has violated mandatory requirement of SA 220. | 2 |
| Q.2 | (b) | Discussion with Individuals outside the Firm to resolve a difficult matter is permitted as per requirements of SQC 1. | 2 |
| Q.3 | (c) | Statement is not valid because final audit file is to be assembled within 60 days from date of audit report. | 2 |
| Q.4 | (b) | Familiarity Threat | 2 |

Part B (Descriptive Questions)

Q. No. 1 is Compulsory. Attempt ANY TWO from the rest.

- Q.1** (a) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The scope of audit of financial statements includes coverage of all aspects of entity, reliability and sufficiency of financial information and proper disclosure of financial information.

(1 Mark)

In the given situation, CA. Dhruv observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher profits. Since proper disclosure of financial information is covered under the scope of audit, thus, the auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

(1 Mark)

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

(1 Mark)

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Thus, it can be concluded that proper disclosure of financial information is well within scope of audit.

(1 Mark)

(b) Acceptance of Changes in terms of engagement:

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, a significant change in nature or size of the entity's business is one of the factors which may make it appropriate to revise the terms of the audit engagement.

In the given situation, Kamla Limited has diversified its business, and few new products have also been introduced by the company which is indicative of significant change in nature or size of the entity's business. In view of the above, CA. Puneet can agree to the request made by the management to change the terms of the audit engagement. Therefore, the request of Management to change the terms of audit engagement is appropriate.

(2 Marks)

Circumstance in which client can request the auditor to change the engagement:

A request from the entity for the auditor to change the terms of the audit engagement may result from

- (a) a change in circumstances affecting the need for the service,
- (b) a misunderstanding as to the nature of an audit as originally requested or
- (c) a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

3 Marks – 1 Mark for 1 point (Any Three)

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Q.2 Considerations as to integrity of clients:

As per SQC 1, with regard to the integrity of a client, matters that the firm considers include, for example:

- (1) The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- (2) The nature of the client's operations, including its business practices.
- (3) Information concerning the attitude of the client's principal owners, key management and TCWG towards such matters as aggressive interpretation of ASs and the internal control environment.
- (4) Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- (5) Indications of an inappropriate limitation in the scope of work.
- (6) Indications that the client might be involved in money laundering or other criminal activities.
- (7) The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

Marking Scheme – 1 Mark for 1 Correct Point (Any five Points)

Q.3 Inherent Limitations of Audit:

As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing” the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which may arise from:

- (1) **The Nature of Financial Reporting:** Preparation of F.S. involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors. **(1 Mark)**
- (2) **Nature of Audit Procedures:** There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example:

Auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor’s ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as requested. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor’s ability to obtain audit evidence. **(1 Mark)**
- (3) **Not in Nature of Investigation:** Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that F.S. are free from material misstatements due to frauds or errors. **(1 Mark)**
- (4) **Timeliness of Financial Reporting & the Balance between Benefit & Cost:** The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it. **(1 Mark)**
- (5) **Future Events:** Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events. **(1 Mark)**

- Q.4** In the given situation, holding shares by CA Sudhakar involves financial interest in the company and is in nature of self-interest threat. Though he has come to hold shares due to nomination made by his distant relative before accepting the appointment.

Chartered Accountants have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.

Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to comply with the fundamental principles to an acceptable level.

(1 Mark)

To address the issue, the following guiding principles are to be applied: -

- (a) For the public to have confidence in the quality of audit, it is essential that auditors should always be and appear to be independent of the entities that they are auditing.
- (b) Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- (c) When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguard measures need to be recorded in a form that can serve as evidence of compliance with due process.
- (d) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

3 Marks – 1 Mark for 1 point (Any Three)

Considering above, holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence. Therefore, CA Sudhakar should take steps to eliminate the threat by selling shares immediately before accepting the appointment and in the absence of same, he should not accept the appointment as an auditor.

(1 Mark)



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