

Suggested Answers and Marking Scheme

MTP 2 (Ch. 3 – Audit Planning, Strategy and Execution & Ch. 4 – Materiality, Risk Assessment and IC)

Marks: 40

Time: 1 hr. 15 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) | Update the overall audit strategy by revising materiality levels, expanding substantive procedures and reconsidering the timing of detailed testing due to unexpected events. | 2 |
| Reason:

SA 300 requires updating the overall audit strategy and plan when unexpected events or changes in conditions arise. Mid-year recalibration with inadequate documentation increases risk and necessitates revised materiality and expanded procedures. | | | |
| Q.2 | (a) | Treat this as a high-risk estimate, evaluate management's assumptions for reasonableness, and assess indicators of possible management bias. | 2 |
| Reason:

SA 540 mandates evaluation of reasonableness of assumptions, indicators of management bias, and necessitates deeper testing for high-estimation uncertainty. Management's unsupported reduction of default probability requires heightened scrutiny. | | | |
| Q.3 | (b) | Evaluate the adequacy of the expert's work, corroborate findings with additional evidence and consider implications for audit opinion. | 2 |
| Reason:

SA 620 states the auditor must evaluate the adequacy of the expert's work and correlate findings with audit evidence. Expert's conclusion cannot be accepted blindly; auditor remains responsible for the opinion and must corroborate. | | | |
| Q.4 | (c) | Monitoring Activities – Because periodic reviews of control implementation and follow-up on deficiencies are inadequate. | 2 |
| Reason:

Audit Committee's lack of focus on remediation and control effectiveness indicates weak oversight and poor follow-up, directly impairing COSO's Monitoring Activities component. | | | |
| Q.5 | (a) | Recommend immediate removal of elevated rights and require re-design of access control matrix, ensuring only defined levels hold authorization powers as per SOP. | 2 |

Reason:

Elevated approval rights violate SOP limits and create override risks; access must align with delegated authority to preserve control reliability.

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|------------|------------|---|----------|
| Q.6 | (a) | Consistent failure to perform periodic physical inventory verification, despite prior-year auditor recommendations, resulting in unresolved mismatches. | 2 |
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Reason:

Systemic, unresolved control failures despite prior recommendations represent a significant deficiency under SA 265 requiring communication to TCWG.



Part B (Descriptive Questions)

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

Q.1 (a) Using Direct Assistance of Internal Auditor:

- As per SA 610, “Using the Work of Internal Auditors”, prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:
 - (i) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor’s instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
 - (ii) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity. (2 Marks)
- If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. (1 Mark)
- The external auditor shall not use an internal auditor to provide direct assistance if:
 - (a) There are significant threats to the objectivity of the internal auditor; or
 - (b) The internal auditor lacks sufficient competence to perform the proposed work. (1 Mark)
- In the current scenario, STU & Associates are the statutory auditors of First and Last Ltd., a listed company. CA. L, the engagement partner, designed certain substantive procedures on some selected assertions in response to the assessed risks of material misstatements for the year, which were not previously examined. Mr. X, head of the internal audit department, reports to the audit committee. A senior audit team member decides to involve Mr. X in performing these substantive procedures.
- As a result, the STU & Associates is required to obtain written agreements from both the entity and the internal auditors regarding their cooperation and confidentiality. Further, using an internal auditor to provide direct assistance could prove to be counter-productive and defeat the very purpose of designing such substantive procedures.

Conclusion: Decision of senior engagement team member to use Mr. X to provide direct assistance on above said matters is not in order as it is not in accordance with SA 610.

(1 Mark)

(b) Deficiencies in Internal Control System:

Internal Checks and Internal Audit are important constituents of Accounting Controls. Internal check system implies organization of the overall system of book-keeping and arrangement of Staff duties in such a way that no one person can carry through a transaction and record every aspect thereof.

In the present case, person in charge of inventory is not only responsible for inflow an outflow of inventory from store house but also responsible for purchase and maintaining inventory records.

So, in this case, one of the essential of internal check system that independent and complete control should not be given to a single person has been violated. (1 Mark)

General Conditions pertaining to internal check:

- (1) No single person should have an independent control over any important aspect of the business.
- (2) Duties of staff should be changed from time to time without any previous notice so that the same officer does not, without a break, perform same function for a considerable length of time.
- (3) Every member of the staff should be encouraged to go on leave at least once in a year.
- (4) Persons having physical custody of assets must not be permitted to have access to the books of account.
- (5) To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.
- (6) Budgetary control may be introduced, it would enable management to review from time to time the progress of trading activities.
- (7) Financial and administrative powers should be distributed judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.
- (8) Procedures should be laid down for periodical verification & testing of different sections of accounting records to ensure that they are accurate.

[1 Mark for each correct point (Any Four) – 4 Marks]

(c) Standard Operating Procedures (SOPs) of assessment and evaluation of control:

- (1) Enterprise Risk Management: Organization having robust processes to identify & mitigate risks across the entity & its periodical review will assist in early identification of weaknesses in internal control and taking effective control measures. In such entities, surprises of failures in controls is likely to be few.
- (2) Segregation of Job Responsibilities: Segregation of duties is an important element of control which ensures that no two commercial activities should be conducted by the same person.
- (3) Job Rotation in Sensitive Areas: In key commercial functions, job rotation is regularly followed to avoid degeneration of controls.
- (4) Documents of delegation of Financial Powers: Document on delegation of powers allows controls to be clearly operated without being dependant on individuals.
- (5) IT based Controls: In an IT Environment, it is much easier to embed controls through the system instead of being human dependant. The failure rate for IT embedded controls is likely to be low, is likely to have better audit trail & is thus easier to monitor.

[1 Mark for each correct point (Any Four) – 4 Marks]

Q.2 (a) Consideration of Materiality in evaluation of Uncorrected Misstatements:

- As per SA 450 "Evaluation of Misstatements Identified during the Audit", the auditor is required to reassess materiality, in accordance with SA 320 "Materiality in Planning and Performing an Audit", before evaluating the impact of uncorrected misstatements. This reassessment is crucial to confirm the ongoing appropriateness of materiality in light of the entity's actual financial results. (1 Mark)
- The determination of materiality under SA 320 often relies on estimates of the entity's financial results, given that the actual results may not be known during the early stages of the audit. Therefore, before the auditor proceeds to assess the effect of uncorrected misstatements, it becomes necessary to adjust the materiality calculated under SA 320 based on the now available actual financial results. (1 Mark)
- SA 320 outlines that, as the audit progresses, materiality may be revised for the financial statements as a whole or for specific classes of transactions, account balances, or disclosures. This revision is prompted by the auditor's awareness of information that would have led to a different initial determination. Typically, significant revisions occur before the evaluation of uncorrected misstatements. However, if the reassessment of materiality under SA 320 results in a lower amount, the auditor must reconsider performance materiality and the appropriateness of the audit procedures' nature, timing, and extent. This is crucial for obtaining sufficient and appropriate audit evidence on which to base the audit opinion. (2 Marks)
- In the present case involving Manhattan Constructions Private Limited, it has been identified that the materiality calculated at the beginning of the audit for Sales was based on estimates provided by the management. The management extrapolated sales for the full year using the actual amount of 11 months, but since the company experiences significant monthly variations in sales, the actual sales for the last month were only 25% of the estimated figure. This discrepancy arose due to an unexpected increase in stamp duty rates by the government in that region.

Conclusion: Mr. Sushil, auditor, must review and re-assess the materiality initially determined under SA 320 to ensure its continued validity in light of the actual financial results. If the re-assessed materiality is lower than the previously calculated amount, Mr. Sushil must reconsider performance materiality and the appropriateness of the nature, timing, and extent of further audit procedures.

This meticulous approach is essential to gather sufficient and appropriate audit evidence, enabling Mr. Sushil to form an independent and objective opinion on the financial statements of Manhattan Constructions Private Limited. (1 Mark)

(b) Testing the relevance & reasonableness of assumptions & methods used by the auditor's expert:

- As per SA 620, "Using the Work of an Auditor's Expert", when an auditor uses the work of an expert, they must evaluate whether the expert's work is adequate for the auditor's purposes. In the given case, CAA, statutory auditor of Datacom Ltd., is using the valuation report of Mr. S, a registered valuer, for auditing derivative instruments. CAA also observed that an expert's work involves the use of significant assumptions and methods. Accordingly, he must assess the relevance and reasonableness of the expert's assumptions, methods, and findings in the circumstances as per SA 620. (1.5 Mark)

- SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures”, discusses the **assumptions and methods** used by management in making accounting estimates, including the use in some cases of highly specialised, entity-developed models. Although that discussion is written in the context of the auditor obtaining sufficient appropriate audit evidence regarding management’s assumptions and methods, it may also **assist the auditor when evaluating an auditor’s expert’s assumptions and methods**.

(1.5 Mark)

- When an auditor’s expert’s work involves the use of significant assumptions and methods, **factors relevant to the auditor’s evaluation of those assumptions and methods** include whether they are:
 - (i) Generally accepted within the auditor’s expert’s field;
 - (ii) Consistent with the requirements of the applicable financial reporting framework;
 - (iii) Dependent on the use of specialised models; and
 - (iv) Consistent with those of management, and if not, the reason for, and effects of, the differences.

(2 Marks)

(c) Re-evaluation of the Materiality Concept:

- SA 320 “Materiality in Planning and Performing an Audit”, requires the auditor to determine materiality for the financial statement as a whole, while establishing the overall audit strategy.
- If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the F.S. as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. **(1 Mark)**
- The auditor shall revise materiality for the financial statements as a whole and if applicable the materiality levels for particular classes of transactions, account balances or disclosures, in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. **(1 Mark)**
- If the auditor concludes a lower materiality for the same, then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate. **(1 Mark)**
- In the instant case, auditor has applied the concept of materiality for the financial statements as a whole. But he wants to re-evaluate the materiality concept, on the basis of additional information of significant contractual arrangements which draws attention to a particular aspect of the company’s business.

Conclusion: Auditor can re-evaluate the materiality concepts after considering the necessity of such revision. **(1 Mark)**

Q.3 (a) Review of outcome of Accounting Estimates:

- As per SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall **review the outcome of accounting estimates** included in the prior period financial statements, or, where applicable, their **subsequent re-estimation** for the purpose of the current period. The nature and extent of the auditor’s review take account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. **(1 Mark)**
- The **outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements**. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:
 - (a) Information regarding the effectiveness of management’s prior period estimation process, from which the auditor can judge the likely effectiveness of management’s current process.
 - (b) Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
 - (c) Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. **(3 Marks)**
- The review of prior period accounting estimates may also assist the auditor, in the current period, in **identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias**. The auditor’s professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time. **(1 Mark)**

Conclusion: Management is not correct in refusing the relevant information to the auditor.

(b) Communicating Deficiencies in Internal Control:

- SA 265 on “Communicating Deficiencies in Internal Control to TCWG and Management”, deals with the auditor’s responsibility to communicate appropriately to TCWG and management deficiencies in internal control that the auditor has identified in an audit of financial statements. The auditor, CA Q shall **communicate significant deficiencies in internal control identified during the audit to TCWG on a timely basis in writing**. CA Q shall also **communicate to management at an appropriate level of responsibility** on a timely basis. **(1 Mark)**
- The auditor shall include in the written communication of significant deficiencies in internal control:
 - (1) A **description of the deficiencies and an explanation of their potential effects**; and **(1 Mark)**
 - (2) Sufficient information to enable TCWG and management to understand the context of the communication. In particular, the auditor shall explain that:
 - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

- (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
- (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance. **(3 Marks)**

(c) Using the work of Branch Auditors:

- SA 600 states that the **principal auditor would not be responsible in respect of the work entrusted to the other auditors**, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors. **(1 Mark)**
- When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his **report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by other auditors have been included in the financial information of entity**, e.g., number of divisions/branches/subsidiaries or other components audited by other auditors. **(2 Marks)**
- In the given situation, nothing has come to light of statutory auditor which would arouse his suspicion about reliability of work performed by branch auditor. Therefore, he would not be responsible for work performed by branch auditor. Further, it should be **clearly stated in the report that 96 production and sales units of company have been audited by branch auditors**. **(1 Mark)**

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Link for Resources (Revision Videos, MTPs, Amendments, Charts, etc.) and Inquiries			
1	Youtube Channel	https://www.youtube.com/@altclassesca9193	 www.altclasses.in
2	Telegram Channel	https://t.me/altclasses	
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