Test Series: April, 2023

MOCK TEST PAPER 2

INTERMEDIATE: GROUP – II

PAPER – 6: AUDITING AND ASSURANCE

SUGGESTED ANSWERS / HINTS

Division A-Multiple Choice Questions

Case Scenario 1

Question No.	Answer
1.	**(a)** attesting to the truth and fairness of presentation of the financial statements and related disclosures
2.	**(d)** Misrepresentation in or intentional omission from financial statements
3.	**(a)** Misappropriation of assets
4.	**(b)** Capital Reserve

Case Scenario 2

Question No.	Answer
1.	**(c)** II and III
2.	**(b)** Stratification
3.	**(c)** i, ii, iii, iv, v, vi, vii, viii, ix, x, xi.
4.	**(a)** Professional Skepticism
5.	**(b)** (I), (II) & (III)

General MCQ's

1. **(a)**

2. **(c)**

3. **(a)**

4. **(c)**

5. **(b)**

6. **(b)**

7. **(a)**

8. **(d)**

9. **(a)**

10. **(b)**

11. **(c)**

12. **(b)**

Division B -Descriptive Answers

1. **(i)** **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.

(ii) Incorrect: Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise.

Asset classification would be borrower-wise and not facility-wise.

(iii) Incorrect: When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

(iv) Incorrect: The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex. If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

(v) 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.

(vi) Incorrect: Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

(vii) Incorrect: The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

(viii) Incorrect: Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example -a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases, quantitative limits of materiality are specified.

2. (a) Overall Objectives of the Independent Auditor: As per SA-200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", in conducting an audit of financial statements, the overall objectives of the auditor are:

(i) 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

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

In the given case of JP Ltd, CA Jatin expressed his opinion on the financial statements of JP Ltd without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not. Therefore, it can be concluded that CA Jatin did not comply with the objective of audit as stated in SA 200.

(b) In establishing the overall audit strategy, auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. The cases by which auditor can ascertain the reporting objectives of the engagement are:

(i) The entity's timetable for reporting, such as at interim and final stages.

(ii) The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.

(iii) The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.

(iv) The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

(c) In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

i. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

ii. The risks arising from the characteristics of the control, including whether it is manual or automated;

iii. The effectiveness of general IT-controls;

iv. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control;

v. Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

vi. The risks of material misstatement and the extent of reliance on the control.

(d) At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal Controls Memo or Management Letter.
- Communicate in writing any significant deficiencies to Those Charged With Governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

3. **(a)** Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including :

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

(b) In the given question, CA Amrit was removed by Kritika Ltd. before the expiry of his term and Kritika Ltd wants to appoint an auditor other than retiring auditor i.e CA Amrit who was removed.

Section 140(4) lays down procedure to appoint an auditor other than retiring auditor who was removed-

(1) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under **sub-section (2) of section 139**.

(2) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

(3) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-

(a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and

(b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Provided further that if a copy of representation is not sent as aforesaid, a copy thereof shall be field with the Registrar.

Curtailing right of the auditor regarding circulation of copy of representation in the case of appointment of auditor other than retiring auditor under section 140(4) of the companies act, 2013:

If the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by **section 140(4)** of the Companies Act, 2013 are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

(c) With the introduction of the Companies Act 2013, there is greater emphasis given to internal financial controls (IFC) from a regulatory point of view. Directors and those charged with governance (including Board of directors, Audit committee) are responsible for the implementation of internal controls framework within the company. The auditors' responsibilities now include reporting on Internal Financial Controls over Financial Reporting which include and understanding IT environment of the company and relevant risks & controls.

Following are some situations in which IT will be relevant to an audit,

(i) Increased use of Systems and Application software in Business (for example, use of ERPs)

(ii) Complexity of transactions has increased (multiple systems, network of systems)

(iii) Hi-tech nature of business (Telecom, e-Commerce).

(iv) Volume of transactions are high (Insurance, Banking, Railways ticketing).

(v) Company Policy (Compliance).

(vi) Regulatory requirements - Companies Act 2013 IFC, IT Act 2008.

(vii) Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE

(viii) Increases efficiency and effectiveness of audit.

(d) **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.

The provisions of removal of auditor before expiry of his term are also meant to safeguard auditor's independence by imposing strict conditions like prior approval of Central government.

4. **(a) Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

(i) Sharing of expertise.

(ii) Advantage of mutual consultation.

(iii) Lower workload.

(iv) Better quality of performance.

(v) Improved service to the client.

(vi) Displacement of the auditor of the company taken over in a takeover often obviated.

(vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance

(b) Corporate Social Responsibility (CSR): Since Mayank Ltd is covered under section 135 of the Companies Act, the following matters shall be disclosed by the Mayank Ltd with regard to CSR activities:

(i) amount required to be spent by the company during the year,

(ii) amount of expenditure incurred,

(iii) shortfall at the end of the year,

(iv) total of previous years shortfall,

(v) reason for shortfall,

(vi) nature of CSR activities,

(vii) details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,

(viii) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

(c) Audit procedure to establish Rights and Obligations of the entity over PPE:

(i) In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, CA Mehta, the statutory auditor of ABC Ltd, 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. Verify whether the PPE additions have been approved by authorized personnel.

(ii) For all additions to land, building in particular, CA Mehta, the statutory auditor of ABC Ltd, should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

(iii) The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.

(iv) 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, CA Mehta, the statutory auditor of ABC Ltd 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.

(v) In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

(d) No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of Jagat Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

(i) the said asset is identifiable;

(ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;

(iii) it is probable that future economic benefits associated with the asset will flow to the entity;

(iv) the cost of the item can be measured reliably.

5. (a) Audit Procedure Regarding Opening Balances: The newly appointed auditor of Parag Ltd shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor of Parag Ltd shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(1) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss.

(2) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(3) Performing one or more of the following:

  (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements.

  (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

  (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

(b) Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

(i) **Preparing the financial statements** in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

(ii) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

(c) Following points merit consideration while auditing the element of ROOM SALES during the audit of a Hotel:-

(1) The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.

(2) The source of these entries is the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.

(3) Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

(4) In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.

(5) Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate.

(6) Special emphasis to be laid on receipts through Credit Cards.

(7) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

(d) Powers of C&AG

The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

i. To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

ii. To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

iii. To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

iv. In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

6. (a) **Audit Approach while Auditing the Operating Expenses of a Bank:**

(i) **Internal Controls:** The auditor should study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.

(ii) **Divergent Trends:** The auditor should examine whether there are any divergent trends in respect of major items of expenses.

(iii) **Substantive analytical Procedures:** The auditor should perform substantive analytical procedures in respect of these expenses. eg. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

(iv) **Vouching & Verification:** The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

(b) **Computation of Drawing Power:**

(i) **Bank's Duties:** 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.

(ii) **Auditor's Concern:** The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. The audited Annual Report submitted by the borrower should be scrutinized 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.

(iii) **Computation of DP:** 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.

(iv) **Stock Audit:** The stock audit should be carried out by the bank for all accounts having funded exposure of more than 15 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.

(c) **The receipt of income of NGO may be checked on the following lines:**

(i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) **Subscriptions:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/ circulars/periodicals. Check the receipts with subscription rate schedule.

(v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

(d) Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

i. that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or

ii. that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or

iii. that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co- operative society is in danger, Central government can direct for special audit.

(e) Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:

(i) Materiality: It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.

(ii) Risk of material misstatement: It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

- Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
- Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) Size of a population: It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.