

MOCK TEST PAPER 1
INTERMEDIATE: GROUP – II
PAPER – 6: AUDITING AND ASSURANCE
SUGGESTED ANSWERS / HINTS
Division A-Multiple Choice Questions

Case Scenario 1

Question No.	Answer
1.1	(a) The statutory auditor is required to provide details of differences in quarterly statements filed with bankers with its books of accounts.
1.2	(c) Amount of default along with period of default is required to be reported.
1.3	(a) TDS payable of ₹1.00 lac in financial statements shall not be reported as it does not meet necessary reporting requirements.
1.4	(c) whether Property, Plant and Equipment have been physically verified by the auditor during the year; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account
1.5	(c) There is no requirement to report losses reflected in statement of profit and loss under CARO, 2020.

Case Scenario 2

Question No.	Answer
2.1	(b) reasonable, high, complete, in totality, errors
2.2	(c) Due to professional training and knowledge acquired by auditor, he can authenticate genuineness of documents.
2.3	(b) The information being relied upon by auditor cannot lose its reliability due to historical nature of financial information presented in financial statements.
2.4	(c) Its chief advantage lies in safeguarding financial interest of management.
2.5	(d) For all companies in India, audit is legally obligatory.

General MCQ's

1. (a)
2. (d)
3. (c)
4. (d)
5. (b)
6. (d)
7. (b)
8. (d)

9. (a)

10. (c)

Division B -Descriptive Answers

1. (i) **Correct:** 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.
- (ii) **Incorrect:** The audit procedure used by the auditor of XYZ Ltd. is known as “Inspection”. Whereas Observation consists of looking at a process or procedure being performed by others.
- (iii) **Incorrect:** The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor’s resources.
- (iv) **Incorrect:** Dividends are recognised in the statement of profit and loss only when:
- (i) the entity’s right to receive payment of the dividend is established;
 - (ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and
 - (iii) the amount of the dividend can be measured reliably.
- (v) **Incorrect:** Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received.
- (vi) **Incorrect:** Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives.
- Objective of Application system acquisition, development, and maintenance is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.
- (vii) **Correct:** As per section 141 (3)(d), a person shall not be eligible for appointment as an auditor of a company namely- a person, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. From the above it can be concluded that if the partner deals with shares and securities of the audited entity, he would be lacking independence, hence, disqualified to be appointed as an auditor.
- Further, the 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.
- (viii) **Incorrect:** Section 139(7) of the Companies Act, 2013, provides that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.
2. (a) 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:
- ◆ Audit evidence that contradicts other audit evidence obtained.

- ◆ Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
 - ◆ Conditions that may indicate possible fraud.
 - ◆ Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
 - ◆ 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.
- (b) As per SA-315, “Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment”, the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. **For Example**
- The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.
 - Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
 - Technological developments, such as those related to the entity’s products
 - Energy supply and cost.
 - The effect of regulation on entity operations.

- (c) SA 560, “Subsequent Events” deals with the auditor’s responsibilities relating to subsequent events in an audit of financial statements.

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

- (a) Those that provide evidence of conditions that existed at the date of the financial statements; and
- (b) Those that provide evidence of conditions that arose after the date of the financial statements.

SA 700 explains that the date of the auditor’s report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

Subsequent events refer to events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report.

- (d) In today’s digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous.

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can

benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- ◆ Check completeness of data and population that is used in either test of controls or substantive audit tests.
- ◆ Selection of audit samples – random sampling, systematic sampling.
- ◆ Re-computation of balances – reconstruction of trial balance from transaction data.
- ◆ Reperformance of mathematical calculations – depreciation, bank interest calculation.
- ◆ Analysis of journal entries as required by SA 240.
- ◆ Fraud investigation.
- ◆ Evaluating impact of control deficiencies.

3. (a) As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (a) Whether the risk is a risk of fraud;
 - (b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
 - (c) The complexity of transactions;
 - (d) Whether the risk involves significant transactions with related parties;
 - (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
 - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.
- (b) Section 141(3)(g) of Companies Act, 2013 states that a partner of a firm holding appointment as its auditor shall not be eligible for appointment of auditor of a company if such partner is at the date of such appointment or reappointment is holding appointment of more than 20 companies other than OPC, dormant companies, small companies and private companies having paid up share capital of less than ₹100 crores.

The above limit is 20 company audits per partner. Hence, overall limit for the firm is 40 company audits in given case excluding audits of OPC, dormant companies, small companies and private companies having paid up share capital of less than ₹100 crores.

In accordance with above law provisions, eligibility of firm is arrived as under: -

Total number of company audits held by firm	40
Less: companies excluded from ceiling	

Small companies	2	
OPC	1	
*Private cos with share capital of less than 100 crore	<u>5</u>	<u>8</u>
Companies hit by provisions of section 141(3)(g)		<u>32</u>

*Turnover limit for private companies is irrelevant as under relevant provisions, exemption criterion is in respect of private companies having paid up share capital of less than ₹100 crores. As all private companies have paid up share capital of ₹15 crore each, these are excluded from ceiling under section 141(3)(g).

Therefore, out of 40 company audits held by XY & Co., only 32 audit assignments are covered under provisions of section 141(3)(g).

Hence, firm can very well accept appointment of two more private companies having paid up capital in excess of ₹100 crore as only 32 companies are hit by provisions of section 141(3)(g).

Therefore, audit of two private companies can be accepted as discussed above.

- (c) **Understanding and Documenting Automated Environment:** Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

- (d) Rule 3 of Companies (Cost Records and Audit) Rules, 2014 provides that the class of companies engaged in production of goods or providing services, having an annual turnover from all its products and services of ₹35 crore or more during the immediately preceding financial year are required to include cost records for such products or services in their books of accounts.

However, this rule excludes a company classified as a **micro enterprise or small enterprise** including as per turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006.

In the given situation, turnover of company is ₹35 crore or more for year 2022-23. However, it is registered as a small enterprise under Micro, Small and Medium Enterprises Development Act, 2006. Therefore, this rule is not applicable to the company.

Hence, the company is not required to maintain cost records in year 2023-24.

4. (a) Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.
- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
 - A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
 - Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
 - A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
- (b) **Few Techniques of how receipts are suppressed are:**
- (1) *Teeming and Lading*: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.
 - (2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.
 - (3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.
 - (4) Not accounting for cash sales fully.
 - (5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.
 - (6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.
- (c) (i) **Assertions about account balances at the period end:**
- (a) Existence – assets, liabilities, and equity interests exist.
 - (b) Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - (c) Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.
 - (d) Valuation and allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
- (ii) **The specific assertions are as follows:**
- (1) the firm owns the plant and machinery;
 - (2) the historical cost of plant and machinery is ₹ 4 lacs;
 - (3) the plant and machinery physically exists;
 - (4) the asset is being utilised in the business of the company productively;
 - (5) total charge of depreciation on this asset is ₹ 1,66,000 to date on which ₹ 26,000 relates to the year in respect of which the accounts are drawn up; and

- (6) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

- 5. (a) **Tolerable misstatement** is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

Total rate of deviation / Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

- (b) **Factors to be considered to form an opinion:** The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- (a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained
- (b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate.
- (c) The evaluations required
 - (i) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
 - (ii) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.
- (c) The audit procedure generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis is as under:
 - (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
 - (ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
 - (iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
 - (iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.

(d) The information system, including the related business processes, relevant to financial reporting and communication

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as:

- (i) The classes of transactions in the entity's operations that are significant to the financial statements;
- (ii) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- (iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
- (iv) How the information system captures events and conditions that are significant to the financial statements;
- (v) The financial reporting process used to prepare the entity's financial statements;
- (vi) Controls surrounding journal entries.

6. (a) The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion. Therefore, provision in above case is arrived as under: -

Outstanding balance as on 31.3.23	₹ 50 lakhs
Less: Value of security	<u>₹ 40 lakhs</u>
Unsecured portion	<u>₹ 10 lakhs</u>

Therefore, outstanding balance of ₹50 lakhs is secured to the tune of ₹40 lakhs and balance ₹ 10 lakhs is unsecured.

Provision calculation

25% of secured part i.e., 25% of ₹40 lakhs	₹ 10 lakhs
100% of unsecured part i.e., 100% of ₹10 lakhs	<u>₹ 10 lakhs</u>
Required provision	<u>₹ 20 lakhs</u>

Therefore, provision made by branch is not proper. It should have made provision of ₹20 lakhs instead of ₹ 7.50 lakhs.

(b) Audit Programme for local bodies

- (i) The Local Fund Audit Wing of the State Government is generally in-charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.
- (ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.
- (iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
- (iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

- (v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
 - (vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.
- (c) The important points to be examined in the lease agreement are:**
- (i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
 - (ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
 - (iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
 - (iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.
- (d) 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.
- (e) Advances under Consortium:** Asset Classification of Consortium Advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.
- The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.