

**MOCK TEST PAPER 2**  
**INTERMEDIATE (IPC): GROUP – II**  
**PAPER – 6: AUDITING AND ASSURANCE**  
**SUGGESTED ANSWERS / HINTS**  
**Division A-Multiple Choice Questions**

**Case Scenario 1**

1. (b)
2. (b)
3. (d)
4. (d)
5. (b)

**Case Scenario 2**

1. (d)
2. (c)
3. (b)
4. (b)
5. (c)

**General MCQs**

1. (c)
2. (b)
3. (b)
4. (c)
5. (b)

**Division B -Descriptive Answers**

1. (i) **Correct:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.
- (ii) **Correct:** Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable
- (iii) **Correct:** Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection,

observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

- (iv) **Correct:** The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.
- (v) **Correct:** Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that, if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way.
- (vi) **Correct:** The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.
- (vii) **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.
- (viii) **Incorrect:** There are basically four types of audit tests that should be used in an automated environment. They are inquiry, observation, inspection and re-performance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.

2. (a) **Powers of C & AG in performance of his duties:** The Comptroller and Auditor General's (Duties, Powers and Condition of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties:

- (i) To inspect any an office accounts under the control of the union or a State Government including office responsible for creation of 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 preparation of any account or report, which is his duty to prepare.

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 transaction as he may determine.

- (b) Fraud in the form of misappropriation of goods is still more difficult to detect; for this, management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists.

**(c) Duties of Debenture Trustee:**

As per section 71 of the Companies Act, 2013 duties of debenture trustees are as follows:

- (i) inform the debenture holders immediately of any breach of the terms of issue of debentures or covenants of the trust deed;
- (ii) ensure that the debentures have been converted or redeemed in accordance with the terms of the issue of debentures;
- (iii) call for periodical status or performance reports from the company;
- (iv) ensure that the assets of the company issuing debentures and of the guarantors, if any, are sufficient to discharge the interest and principal amount at all times and that such assets are free from any other encumbrances except those which are specifically agreed to by the debenture holders;
- (v) perform such acts as are necessary for the protection of the interest of the debenture holders and do all other acts as are necessary in order to resolve the grievances of the debenture holders.

**(d) Sample Selection:**

CA. X should obtain the knowledge before using the sampling methods. The principal methods are as follows:

- (1) Random selection.
- (2) Systematic selection.
- (3) Monetary Unit sampling.
- (4) Haphazard selection.
- (5) Block selection.

**Advantages of Statistical Sampling in Auditing:**

- (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (ii) The sample selection is more objective and thereby more defensible.
- (iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

3. (a) **Information which assist the Auditor in accepting and continuing of relationship with Client:**  
As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:
- (i) The integrity of the principal owners, key management and those charged with governance of the entity;
  - (ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
  - (iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and
  - (iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.
- (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) The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
- (a) Discuss the matter with management and, where appropriate, those charged with governance.
  - (b) Determine whether the financial statements need amendment and If so,
  - (c) Inquire how management intends to address the matter in the financial statements.
- (d) Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

#### **Analytical Procedures in Planning the Audit**

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

4. (a) **Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as,** “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

From the above definition, it is clear that **internal financial controls are** the policies and procedures adopted by the company for:

1. ensuring the orderly and efficient conduct of its business, including adherence to company’s policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information.”

**(b) Power and fuel expense -**

- ☐ Obtain a month wise expense schedule along with the power bills.
- ☐ Verify if expense has been recorded for all 12 months.
- ☐ Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.
- ☐ In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

**(c) For Verification of Existence of Trade Receivables, the auditor should check the following :**

- i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice.  
  
Ask for a period-end accounts receivable aging report and trace the balance as per the report to the general ledger.
- ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.
- iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
- iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
- v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.  
The Com
- vii. Where no reply is received, the auditor should perform alternate procedures regarding the

balances. This could include:

- viii. Agreeing the balance to cash received subsequently;
- ix. Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)
- x. If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
- xi. Check that receivables for other than sales or services are not included in the list.
- xii. Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers

**5. (a) Examples of costs to be excluded in determining cost of Inventory:**

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- (i) abnormal amounts of wasted materials, labour, or other production costs;
- (ii) storage costs, unless those costs are necessary in the production process prior to a further production stage;
- (iii) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- (iv) selling and distribution costs.

In the given situation, contention of Z Ltd. is not correct to include all the cost of its inventories while determining the cost of inventory. However, contention of accountant is correct that certain cost should be excluded from the cost of inventories and to be recognised as expenses in period in which they are incurred.

**(b) Re-appointment of auditor:** A retiring auditor may be re-appointed at an annual general meeting, if-

- (i) he is not disqualified for re-appointment.
- (ii) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
- (iii) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
- (iv) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

**(c) Matters to be included in Auditor's report as per CARO 2016:**

- (i) Clause (viii) of Para 3 of CARO, 2016, requires the auditor to report whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).
- (ii) Clause (x) of Para 3 of CARO, 2016, requires the auditor to report whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

(d) **Examples of circumstances to include Emphasis of Matter Paragraph:** As per SA 706 (Revised) on “Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor’s Report”, the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are;

- (a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- (b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor’s report.
- (c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- (d) A major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position.

**6. (a) Financial indicator that may cast significant doubt about the going concern assumption:**

- (i) Net liability or net current liability position.
- (ii) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short term borrowings to finance long term assets.
- (iii) Indications of withdrawal of financial support by trade payables.
- (iv) Negative operating cash flows indicated by historical or prospective financial statements.
- (v) Adverse key financial ratios.
- (vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- (vii) Arrears or discontinuance of dividends.
- (viii) Inability to pay trade payables on due dates.
- (ix) Inability to comply with terms of loan agreements.
- (x) Change from credit to cash-on-delivery transactions with suppliers.
- (xi) Inability to obtain financing for essential new product development or other essential investments.

(b) **Audit against Rules & Orders** – Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made there under. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- (a) they are not inconsistent with any provisions of the Constitution or any laws made there under;
- (b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- (c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

- (d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

**(c) (i) Revenue grants received by Local Bodies:**

Local bodies may receive different types of grants from the state administration. Broadly the revenue grants are of three types:

- (1) *General purpose grants*: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
- (2) *Specific purpose grants*: These grants which are tied to the provision of certain services or performance of certain tasks.
- (3) *Statutory and compensatory grants*: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

- (ii) Propriety audit:** According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Further, it may so happen that a transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

In the given situation, PQR Ltd. being a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in an infructuous expenditure.

Thus, propriety audit should be done for PQR Ltd. to bring out improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations to the notice of the proper authorities of wastefulness in public administration.

- (d) Certificate from a Management's Expert:** In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.

The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

As per SA 500, "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.



**(e) The objectives of the auditor regarding written representation:**

**(i) To obtain written representations**

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

**(ii) To support other evidence**

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

**(iii) To respond appropriately**

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.