MOCK TEST PAPER 1

INTERMEDIATE (NEW): GROUP – II

PAPER – 6: AUDITING AND ASSURANCE

SUGGESTED ANSWERS / HINTS

Division A-Multiple Choice Questions

Case Scenario 1

1. (c)

2. (b)

3. (c)

4. (a)

5. (c)

Case Scenario 2

1. (c)

2. (b)

3. (a)

4. (a)

5. (c)

General MCQs

1. (b)

2. (d)

3. (b)

4. (c)

5. (c)

Division B -Descriptive Answers

1. (i) Incorrect: The objective of audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. In auditing, reasonable assurance can be given which is high level assurance but not absolute assurance. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.

(ii) Incorrect: SQC1" Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

(iii) Incorrect: It is important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.

(iv) Incorrect: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

(v) Incorrect: Section 139(6) of the Companies Act, 2013 lays down that the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company. In the instant case, the proposed appointment of CA. Champ, a practicing Chartered Accountant, as first auditor by the Managing Director of Pigeon Ltd. by himself is in violation of Section 139(6) of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company.

In view of the above, the Managing Director of Pigeon Ltd. should be advised not to appoint the first auditor of the company.

(vi) Incorrect*:* Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

(vii) Incorrect: A LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A "Statement of Accounts and Solvency" in prescribed form shall be filed by every LLP with the Registrar every year.

(viii) Incorrect: Depending on how the business operates, the management may value inventory using First-in first-out (FIFO) or weighted average basis

2. (a) Ethical Requirements Relating to an Audit of Financial Statements: The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :

(i) Integrity;

(ii) Objectivity;

(iii) Professional competence and due care;

(iv) Confidentiality; and

(v) Professional behavior.

(b) The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.

2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.

5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

(c) The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

1. The size and complexity of the entity.

2. The area of the audit.

3. The assessed risks of material misstatement

   Example

   An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.

4. The capabilities and competence of the individual team members performing the audit work.

   Example

   We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity's process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, alongwith the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior's involvement requires judgment, taking into consideration the complexity of the area and the experience of the team.

(d) Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.

2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

3. An unqualified opinion also indicates that:

   (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

   (ii) the financial statements comply with relevant statutory requirements and regulations;

and

(iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

3. (a) Matters to be included in the Auditor's Report under CARO, 2016: The auditor's report on the accounts of a company to which CARO applies shall include a statement on the following matters, namely-

(i) Fixed Assets-

(1) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

(2) whether these fixed assets have been physically verified by the management at reasonable intervals; 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;

(3) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof.

(ii) As per clause (vii) of CARO, 2016, reporting requirements in respect of statutory dues are:

(1) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(2) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).

(b) Control Environment – Component of Internal Control: The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management .

(iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(1) Communication and enforcement of integrity and ethical values – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(2) Commitment to competence – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(3) Participation by those charged with governance –Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(4) Management's philosophy and operating style – Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(5) Organisational structure – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(6) Assignment of authority and responsibility - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(7) Human resource policies and practices – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

(c) Ceiling on number of Audits:

1. Section 141(3)(g) of the Companies Act, 2013 prescribes that a person shall not be eligible for appointment as an auditor of a company namely – a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 crore.

2. In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits.

3. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

(d) The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls, The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).Thus, sample size will increase.
- If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
- When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
- An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
- In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

4. **(a) Applicability of section 177 i.e. Constitution of Audit Committee:** Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

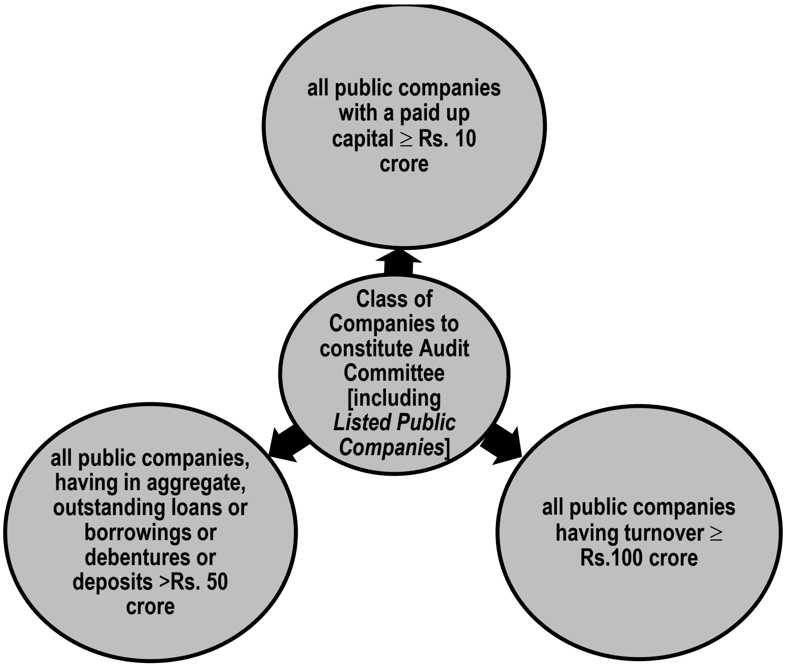

Diagram showing class of companies to constitute Audit Committee

It is important to know that in addition to ***listed public companies***, following classes of companies shall constitute an Audit Committee -

(i) all public companies with a paid up capital of ten crore rupees or more;

(ii) all public companies having turnover of one hundred crore rupees or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more..

(b) When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(c) Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

➢ Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

(d) As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, 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. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of Rs. 1,00,000.

In the instant case, M/s ABC& Co. is an audit firm having partners CA. A, CA. B and CA. C. Mr. D is a relative of CA. A and he is holding shares in XYZ Ltd. of face value of Rs.2,50,000 (25,000 shares x rupees 10 per share). Market value of Rs. 90,000 would not be relevant.

Therefore, M/s ABC& Co. is disqualified for appointment as an auditors of XYZ Ltd. as the relative of CA. A (i.e. partner of M/s ABC& Co.) is holding the securities in XYZ Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

5. (a) The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(iii) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

(b) **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.

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

(c) Completion Memorandum or Audit Documentation Summary.

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

(i) the significant matters identified during the audit.

(ii) how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

(d) Documents to be seen in case of Securities:

Types of Security	Documents etc. to be seen
(i) Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(ii) Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(iii) Hypothecation of goods	Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

6. (a) (i) CAATs: Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.

(ii) Data Analytics: A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information

(iii) Database: A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.

(iv) Information Systems: Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.

(v) Privileged access: A type of super user access to information systems that enforces less or no limits on using that system.

(b) Audit of Cinema: The special steps involved in its audit are stated below-

(i) Verify that entrance to the cinema-hall during show is only through printed tickets;

(ii) Verify that they are serially numbered and bound into books;

(iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(iv) Verify that for advance booking a separate series of tickets is issued;

(v) Verify that the inventory of tickets is kept in the custody of a responsible official.

(vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(vii) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(viii) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.

(ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(c) 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.

(d) (i) Audit procedure for valuation of Loans and Advances and other current assets

- Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60-180 days old, 180-365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.
- Scrutinize the analysis and identify those loans and advances that appear doubtful; Discuss with management their reasons, if any of these loans/ advances are not included in the provision for bad recoverable; Perform further testing where any disputes exist; Reach a final conclusion regarding the adequacy of the bad and doubtful loans/ advances provision.
- Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.

- Check that write-offs or other reductions in the recoverable balances have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.
- Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.

(ii) Audit procedure for valuation of finished goods and goods for resale

- Enquire into what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements.
- Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
- Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60-90 days old, 90-180 days old, 180-385 days old and more than 365 days old (refer screenshot below).
- Follow up any inventories which at time of observance of physical counting were noted as being damaged or obsolete.
- Compare recorded costs with replacement costs. Examine vendor price lists to determine if recorded cost is less than current prices.
- Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included.
- Verify the correct application of lower-of-cost-or-net realizable value principles.