

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. (d)
2. (a)
3. (a)
4. (d)
5. (d)

Case Scenario 2

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

General MCQs

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

Division B -Descriptive Answers

1. (i) **Incorrect:** As per SA 200, 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, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.
- (ii) **Correct:** Audit notes can serve as a guide in framing audit programme in the future as they indicate the weaknesses in the system of the client which specially need to be watched.
- (iii) **Incorrect:** The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

- (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:** As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee 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 CAG prescribe.
 - (vii) **Incorrect:** As per Division I of Schedule III of Companies Act, 2013, the value of imports should be calculated on C.I.F. basis and earning in foreign exchange (on export of goods) on F.O.B. basis.
 - (viii) **Correct:** It is the function of audit to establish that payments have been made validly to persons who are shown to be recipients. For checking the validity of a transaction, it is usually necessary to refer to documentary evidence.
2. (a) (i) **Year end inventory verification:** Existence Assertion.
- (ii) Depreciation has been properly charged on all assets: Valuation Assertion.
- (iii) Title deeds of the lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.
- (iv) All liabilities are properly recorded in the financial statements: Completeness.
- (v) Related party transactions are shown properly: Presentation & Disclosure.
- (b) **Removal of Auditor Before Expiry of Term:** According to **Section 140(1)**, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per **Rule 7 of CAAR, 2014-**
- (i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
 - (ii) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
 - (iii) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.
- It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.
- (c) **Expenses which are essentially of a Revenue Nature**, if incurred for creating an asset or adding to its value for achieving higher productivity, are regarded as expenditure of a capital nature. Examples of capital expenditure are-
- (i) Material and wages- capital expenditure when expended on the construction of a building or erection of machinery.
 - (ii) Legal expenses- capital expenditure when incurred in connection with the purchase of land or building.
 - (iii) Freight- capital expenditure when incurred in respect of purchase of plant and machinery.
 - (iv) Repair- Major repairs of a fixed asset that increases its productivity.
 - (v) Wages- Wages paid on installation costs incurred in Plant & machinery.

- (vi) Interest- Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

(d) Receipt of Donations:

- (i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
- (ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- (iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.
- (iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- (v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- (vi) Foreign Contributions, if any, to receive special attention to compliance with applicable laws and regulations.

3. (a) 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;

(b) Sampling Risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(c) Specific Evaluations by the auditor: In particular, the auditor shall evaluate whether :

- (i) The financial statements adequately disclose the significant accounting policies selected and applied;

- (ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
 - (iii) The accounting estimates made by management are reasonable;
 - (iv) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
 - (v) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
 - (vi) The terminology used in the financial statements, including the title of each financial statement, is appropriate.
- (d) 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.

4. (a) 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.

In view of above, the given statement is incorrect.

- (b) The CARO specifically **exempts** a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees 1 crore as on the balance sheet date and which does not have total borrowings exceeding rupees 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees 10 crore during the financial year as per the financial statements.

From the above, it is clear that ABC Pvt. Ltd. is a subsidiary of XYZ Ltd. and hence not exempt from CARO, 2016 although it is satisfying the conditions that allow exemption to private limited company which is not a subsidiary or holding company of a public company.

- (c) **Applicability of Provisions of Internal Audit:** As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies(Accounts) Rules,2014) shall be required to appoint an internal auditor (which may be either an individual or a partnership firm or a body corporate), namely-

- (1) every listed company;
- (2) every unlisted public company having-
 - (i) paid up share capital of fifty crore rupees or more during the preceding financial year; or
 - (ii) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - (iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (3) every private company having-
 - (i) turnover of two hundred crore rupees or more during the preceding financial year; or
 - (ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In view of above, it would not be correct to state that only Listed Companies are required to appoint an internal auditor.

- (d) Cost Auditor:** Rule 6 of the Companies (Cost Records and audit) rules, 2014 required the companies prescribed under the said rules to appoint an auditor within 180 days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

- (i) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;
- (ii) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;
- (iii) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and
- (iv) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

5. (a) Problematic or unusual relationships between the auditor and management, including:

1. Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
2. Undue time pressures imposed by management to resolve complex or contentious issues.
3. Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
4. Unusual delays by the entity in providing requested information.
5. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
6. Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.

7. An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
8. An unwillingness to address identified deficiencies in internal control on a timely basis.
9. Unwillingness by management to permit the auditor to meet privately with those charged with governance
10. Accounting Policy that appears to be variance with industry norms
11. Frequent changes in accounting estimates that do not appear to result from changed circumstances
12. Tolerance of variations in the entity's code of conduct

(b) Director's Responsibility Statement: According to section 134(3)(c) of the Companies Act, 2013, the report of board of directors on annual accounts shall also include a 'Director's Responsibility Statement'. However, the provisions related to Director's Responsibility Statement are provided under section 134(5) of the Companies Act, 2013 which requires to state that-

- (i) in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;
- (ii) the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
- (iii) the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
- (iv) the directors had prepared the annual accounts on a going concern basis;
- (v) the directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.
- (vi) the directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

(c) Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in management consultancy service as provided in section 144. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which are as under:

- (i) Accounting and book keeping services
- (ii) Internal audit.
- (iii) Design and implementation of any financially information system.
- (iv) Actuarial services
- (v) Investment advisory services.
- (vi) Investment banking services.
- (vii) Rendering of outsourced financial services

(viii) Management services and

(ix) Any other kind of services as may be prescribed

Therefore, CA. NM is advised not to accept the assignment of auditing as the management consultancy service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

(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) Audit of Expenditure of Charitable Institution:

- (i) Vouching payment of grants : Verifys that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the management committee has benefited there from either directly or indirectly.
- (ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.
- (iii) Check payment along with supporting documents in regard to salary and other expenses. Verify that all payments are made after proper sanction by appropriate authority.
- (iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.
- (v) Verifying the cash and bank balances/payments.

(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) If CA Amar checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid Rs. 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Amar may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Amar applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Amar does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

- (e) **Professional judgment is essential to the proper conduct of an audit.** This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:
- (i) Materiality and audit risk.
 - (ii) The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.
 - (iii) Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
 - (iv) The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
 - (v) The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.