

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

1. (a)
2. (a)
3. (d)
4. (b)
5. (a)
6. (b)
7. (d)
8. (a)
9. (c)
10. (a)
11. (d)
12. (d)
13. (d)
14. (c)
15. (c)
16. (b)
17. (d)
18. (a)
19. (a)
20. (d)
21. (c)
22. (b)
23. (d)
24. (b)
25. (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:** 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.
- (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:** 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.
- (v) **Incorrect:** As per **section 140(2)** the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form** with the company and the Registrar, and in case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In this case, the PQR & Co., was also required to file prescribed Form with C & AG of India but it did not file the same. Therefore, it did not comply with the provisions of the Companies Act, 2013.
- (vi) **Incorrect:** Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.
- (vii) **Correct:** The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.
- (viii) **Correct:** The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion

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 :

- (a) Integrity;
- (b) Objectivity;
- (c) Professional competence and due care;
- (d) Confidentiality; and
- (e) Professional behavior.

- (b) Inquiring from Management to Evaluate Subsequent Event:** As per SA 560 “Subsequent Events”, in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-
- (i) Whether new commitments, borrowings or guarantees have been entered into.
 - (ii) Whether sales or acquisitions of assets have occurred or are planned.
 - (iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
 - (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
 - (v) Whether there have been any developments regarding contingencies.
 - (vi) Whether any unusual accounting adjustments have been made or are contemplated.
 - (vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
 - (viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - (ix) Whether any events have occurred that are relevant to the recoverability of assets.
- (c) Development of an Overall Plan:** The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-
- The terms of his engagement and any statutory responsibilities.
 - The nature and timing of reports or other communication.
 - The applicable legal or statutory requirements.
 - The accounting policies adopted by the client and changes in those policies.
 - The effect of new accounting or auditing pronouncements on the audit.
 - The identification of significant audit areas.
 - The setting of materiality levels for audit purposes.
 - Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
 - The degree of reliance he expects to be able to place on accounting system and internal control.
 - Possible rotation of emphasis on specific audit areas.
 - The nature and extent of audit evidence to be obtained.
 - The work of internal auditors and the extent of their involvement, if any, in the audit.
 - The involvement of other auditors in the audit of subsidiaries or branches of the client.
 - The involvement of experts.
 - The allocation of work to be undertaken between joint auditors and the procedures for its

control and review.

- Establishing and coordinating staffing requirements.

(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) (i) **The auditor is required to report as per clause xiv of paragraph 3 of CARO 2016**, whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;
- (ii) **It is duty of the auditor to report as per clause ix of paragraph 3 of CARO 2016**, whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.
- (b) **Limitations of Internal Control:**
- (i) **Internal control can provide only reasonable assurance:** Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.
 - (ii) **Human judgment in decision-making:** Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
 - (iii) **Lack of understanding the purpose:** Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
 - (iv) **Collusion among People:** Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
 - (v) **Judgements by Management:** Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to

implement, and the nature and extent of the risks it chooses to assume.

- (vi) **Limitations in case of Small Entities:** Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

(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 ` 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 $3 \times 20 = 60$ 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) Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling", 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 tests 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 test of controls, the controls are less effective than they actually are, or in the case of tests 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.

4. (a) Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.
2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the secretarial records and

correspondence.

3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.
4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.
5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

(b) Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

(c) 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

5. (a) Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

(b) The Special Steps Involved in the Audit of an Educational Institution are the following:

- (i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.
- (ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.
- (iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
- (iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- (v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.
- (vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.
- (viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.
- (ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.
- (x) Verify rental income from landed property with the rent rolls, etc.
- (xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- (xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.
- (xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

- (xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.
 - (xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
 - (xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.
 - (xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
 - (xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
 - (xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.
 - (xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
 - (xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
 - (xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.
 - (xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
 - (xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.
- (c) Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

- (1) **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

6. (a) Rental Receipts:

- (i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.

- (ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.
- (iii) Scrutinize the account of collecting agent when the rent is collected by such agent.
- (iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.
- (v) Investigate into abnormal rent outstanding.
- (vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.
- (vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.

(b) Vouching- Backbone of Auditing: Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching is not merely to ascertain that money has been paid away, but the auditor aims to obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

- (i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;
- (ii) a transaction pertains to entity and took place during the relevant period;
- (iii) all transactions which have actually occurred have been recorded;
- (iv) all transactions were properly authorised; and
- (v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records.

(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:

- (a) **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
 - (b) **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) **Purchase of Quoted Investment:**
- (i) Ascertain the date of purchase, rate of purchase, nature of investments purchased and nature of transaction, i.e., error cum-dividend/ interest/right/bonus.
 - (ii) Compare the rate of purchase with quotation available. Obtain suitable explanations in case of significant variations.
 - (iii) Verify the amount paid towards purchase of investments.
 - (iv) Trace the amount in the cheque book counterfoils and bank statements.
 - (v) Obtain a schedule of investment from Management for physical verification at the year end.
 - (vi) Verify the investment certificate to confirm title.
 - (vii) Confirm compliance with statutory provisions such as 143(1) of the Companies Act, 2013.
 - (viii) Verify whether investments are duly disclosed in financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements.
- (ii) **Discounted Bill Receivable Dishonoured:**
- (i) Obtain the schedule of discounted bills receivable dishonoured.
 - (ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.
 - (iii) Verify the bills receivable returned by the bank along with bank's advice.
 - (iv) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the trade receivable is also debited.
 - (v) Check that bank commission, if any, charged by the bank has been recovered from the party.