Test Series: October, 2020

MOCK TEST PAPER

FINAL (NEW) COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/HINTS

DIVISION A - MCQs (30 Marks)

Questions no. (1-10) carry 1 Mark each and Questions no. 11-20 carry 2 Marks each.

1. (b)

2. (b)

3. (a)

4. (d)

5. (a)

6. (a)

7. (d)

8. (c)

9. (c)

10. (a)

Questions (11-20) carry 2 Marks each

11. (d)

12. (a)

13. (d)

14. (c)

15. (c)

16. (a)

17. (b)

18. (c)

19. (a)

20. (c)

DIVISION B - DESCRIPTIVE QUESTIONS (70 Marks)

1. (a) Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists: As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a material misstatement of the other information exists, the auditor shall request management to correct the other information. If management:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor shall take appropriate action, including:

(i) Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report;

(ii) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor shall:

(i) If the other information is corrected, perform the procedures necessary in the circumstances; or

(ii) If the other information is not corrected after communicating with those charged with governance, take appropriate action considering the auditor's legal rights and obligations, to seek to have the uncorrected material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared.

(b) As per SA 550, Related Parties, communicating significant matters arising during the audit in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include, non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware; The identification of significant related party transactions that have not been appropriately authorised and approved, which may give rise to suspected fraud; etc.

It may be noted that unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

The auditor is also required to ensure the compliance of Ind AS 24 / AS 18 Related Party Disclosures.

In view of above in the given scenario, the auditor is required to prepare a brief summary of following items to be reported to those charged with governance in accordance with SA 260 **Communication with Those Charged with Governance**:

(i) One of related party transaction amounting 3.25 lac per month i.e. in lieu of marketing services has been noticed of which amount ₹ 0.25 lac per month is exceeds the arm's length price has not been disclosed highlighting the same as related party transactions as per Ind- AS 24 / AS 18 Related Party Disclosures.

(ii) Refusal by CFO of the company to provide the details of related party transaction amounting to rupees 47 lac on the ground that same is perceived to be confidential and cannot be shared with auditors, is not in order, as denying for the related part details of ₹ 47 lac is imposing limitation of scope of auditor in view of SA 705.

(iii) Receipt of free of cost Computers and long-term borrowing (on no agreed terms and repayment of interest and principal) from the Parent Company need separate disclosure in financial statements as per Ind AS 24 / AS 18 Related Party Disclosures.

Further, in case of all the above cases, the auditor would also need to assess his reporting requirements under the clauses (xiii) of Paragraph 3 of CARO 2016 with respect to related party transactions that whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable Accounting Standards.

(c) **Evaluating the Work of Management's Expert:** 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.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

2. (a) **Auditor's responsibility in cases where audit report for an earlier year is qualified** is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements".

As per SA 710, when the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

Refer to both the current period's figures and the corresponding figures in the descriptionofthemattergivingrisetothemodificationwhentheeffectsorpossible effects of the matter on the current period's figures are material; or

In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant case, if ULFA Ltd. does not correct the treatment of depreciation to the extent of rupees 4.25 crore for previous year, the auditor will have to modify his report for both current and previous year's figures as mentioned above. If, however, the figures and provisions are corrected, the auditor need not consider to the earlier year's modification.

(b) Role of Auditor in case of Parent Company and Subsidiary Company: As per SA 600 "Using the Work of Another Auditor", there should be sufficient liaison between the principal auditor (hereinafter referred as auditor of Parent Company and the other auditor (hereinafter referred as auditor of Subsidiary Company).

Role of Principal Auditor (PQR & Associates- Auditor of Parent Company):

(i) It is necessary to issue written communication(s) as a principal auditor to the other auditor.

(ii) The principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

(iii) When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties.

Role of Other Auditor (MNO & Associates- Auditor of Subsidiary Company):

(i) The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention to any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc.

(ii) He should ensure compliance with the relevant statutory requirements.

(iii) The other auditor should respond to the questionnaire sent by Principal Auditor on a timely basis.

(c) Gross Negligence in Conduct of Duties: As per Part I of Second Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he, certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice, under Clause (2); does not exercise due diligence, or is grossly negligent in the conduct of his professional duties, under Clause (7); or fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, under Clause (8).

The primary duty of physical verification and valuation of investments is of the management. However, the auditor's duty is also to verify the physical existence and valuation of investments placed, at least on the last day of the accounting year. The auditor should verify the documentary evidence for the cost/value and physical existence of the investments at the end of the year. He should not blindly rely upon the Management's representation.

In the instant case, such non-verification happened for two years. It also appears that auditors failed to confirm the value of investments from any proper source. In case auditor has simply relied on the management's representation, the auditor has failed to perform his duty.

Conclusion: Accordingly, Mr. Aniket, will be held liable for professional misconduct under Clauses (2), (7) and (8) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

3. **(a)** The areas covered in comprehensive audit naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. However, in general, the covered areas are those of investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc.

Some of the issues examined in comprehensive audit are:

(i) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?

(ii) Have the accepted production or operational outputs been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?

(iii) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?

(iv) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?

(v) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?

(vi) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?

(vii) Are procedures effective and economical?

(viii) Is there any poor or insufficient or inefficient project planning?

(b) **Reporting of Adjustment in Turnover due to Foreign Exchange Fluctuations in Reconciliation Statement:** Any difference between the turnover reported in the Annual Return (GSTR9) and turnover reported in the audited Annual Financial Statement due to foreign exchange fluctuations shall be declared in Sl. No. 5N. Adjustments in turnover due to foreign exchange fluctuations (Less/ Add).

For the purpose of GST Returns, the exchange rate would be ₹ 65 and the exports to be disclosed in the GST Returns would be ₹ 1,30,00,000. For the purpose of accounting records, the exchange rate would be ₹ 68 and the exports recorded in the books would be ₹ 1,36,00,000. The difference in revenue being ₹ 6,00,000 would have to be **reduced** from the Annual turnover as per the financials to arrive at the revenue as per GSTR 9.

(i) Additionally, difference in the amount booked in the accounts and actual amount received being ₹ 70 – ₹ 68 = ₹ 2 x $200,000 = ₹ 400,000 would be **credited to the Profit and Loss Account as Forex Gain** which again needs to be **reduced** from the Annual turnover as per the financials to arrive at the revenue as per GSTR 9.

(ii) Yes, as the difference in the amount booked in the accounts and actual amount received being ₹ 66 – ₹ 68 = (-) 2 x $2,00,000 = (-) ₹ **4,00,000 would be debited to the Profit and Loss account as forex loss** which again needs to be **added from the annual turnover** as per the financials to arrive at the revenue as per FORM GSTR-9.

(c) **Not Exercising Due Diligence:** According to Clause (7) of Part I of Second Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

It is a vital clause which unusually gets attracted whenever it is necessary to judge whether the accountant has honestly and reasonably discharged his duties. The expression negligence covers a wide field and extends from the frontiers of fraud to collateral minor negligence.

Where a Chartered Accountant had not completed his work relating to the audit of the accounts a company and had not submitted his audit report in due time to enable the company to comply with the statutory requirement in this regard, he would be held guilty of professional misconduct under Clause (7).

Since Mr. Dhruv has not completed his audit work in time and consequently could not submit audit report in due time and consequently, company could not comply with the statutory requirements, therefore, the auditor is guilty of professional misconduct under Clause (7) of Part I of the Second Schedule to the Chartered Accountants Act, 1949.

4. **(a)** The auditor should evaluate the Internal Control System in the area of Credit Card operations of a Bank in following manner:

- There should be effective screening of applications with reasonably good credit assessments.
- There should be strict control over storage and issue of cards.
- There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement, in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.
- There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- All the reimbursement (gross of commission) should be immediately charged to the customer's account.
- There should be a system to ensure that statements are sent regularly and promptly to the customer.
- There should be a system to monitor and follow-up customers' payments.
- Payments overdue beyond a reasonable period should be identified and attended to carefully. For defaulting customers, credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.
- There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

(b) **Alternative Way to Tackle the Hostile Management:** While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore, he gives his suggestions and recommendations.

These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit.

The Participative Approach comes to the help of the auditor. In this approach the auditor discusses the ideas for improvements with those managers that have to implement them and make them feel that they have participated in the recommendations made for improvements. By soliciting the views of the operating personnel, the operational audit becomes a co-operative enterprise.

This participative approach encourages the auditee to develop a friendly attitude towards the auditors and look forward to their guidance in a more receptive fashion. When the participative method is adopted then the resistance to change becomes minimal, feelings of hostility disappear and gives room for feelings of mutual trust. Team spirit is developed. The auditors and the auditee together try to achieve the common goal.

The proposed recommendations are discussed with the auditee and modifications as may be agreed upon are incorporated in the operational audit report. With this attitude of the auditor it becomes absolutely easy to implement the proposed suggestions as the auditee themselves take initiative for implementing and the auditor does not have to force any change on the auditee.

Hence, the Operational Auditor of Amazon Manufacturing Unit should adopt the above-mentioned participative approach to tackle the hostile management of Amazon.

(c) Section 21 of the Chartered Accountants Act, 1949 provides that a member is liable for disciplinary action if he is guilty of any professional or "Other Misconduct." Other misconduct has been defined in part IV of the First Schedule and part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. The Council has also laid down that among other things "misappropriation by an office-bearer of a Regional Council of the Institute of a large amount and utilization thereof for his personal use" would amount to "other misconduct".

In the instant case, receipt of personal benefit of ` 40,000 from the tour operator by Mr. Chintamani for organising an international tour as treasurer of a Regional Council of the Institute would amount to other misconduct as per section 21. Therefore, Mr. Chintamani would be held guilty for other misconduct.

5 **(a)** Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics. The data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs.

There are several steps that should be followed to achieve success with CAATs and any of the supporting tools. A suggested approach to benefit from the use of CAATs is given in the illustration below:

- Understand Business Environment including IT
- Define the Objectives and Criteria
- Identify Source and Format of Data
- Extract Data
- Verify the Completeness and Accuracy of Extracted Data
- Apply Criteria on Data Obtained
- Validate and Confirm Results
- Report and Document Results and Conclusions [SA 230]

(b) **Provision for Claim:** No risk can be assumed by the insurer unless the premium is received. According to section 64VB of the Insurance Act, 1938, no insurer should assume any risk in India in respect of any insurance business on which premium is ordinarily payable in India unless and until the premium payable is received or is guaranteed to be paid by such person in such manner and within such time, as may be prescribed, or unless and until deposit of such amount, as may be prescribed, is made in advance in the prescribed manner.

Therefore, in the instant case, LMN Company signed the insurance documents on 31.03.2020 and paid the premium through cheque which later on dishonoured due to insufficiency of funds. In such case insurance premium is not being received, thus, if any accidental incident occurs, insurance company will have no liability to pay claim. In the given case, fire is occurred on 31st March night and premium was not received, the Innocent Insurance Ltd. will not be liable for claim for damage of goods amounting rupees 15 lac hence no provision for claim is required.

(c) **(i)** **Goods in Transits:** As per Division II of Schedule III of the Companies Act, 2013, cost of raw material in transit shall be disclosed as sub-head of raw material and loose tools billed on the company would be shown as separate sub-head of Loose tools under heading of Inventories i.e. part of Current Asset. Thus, disclosure of consolidated amount aggregating the cost of raw material in transit and loose tools is not correct.

(ii) **Provision for Doubtful Debts of Trade Debtors was grouped in "Provisions" under current liabilities:** The term 'doubtful debts' is an adjustment to the carrying amounts of assets, hence no provision is created separately for it as per Ind-AS 37 "Provisions, Contingent Liabilities and Contingent Assets". Thus, provision should be shown as deduction from gross value of (net) trade receivable.

(iii) **Sale Proceeds of Scrap incidental to manufacture were included in "Other** Income": As per Ind-AS 2 "Inventories", sale proceeds of scrap incidental to manufacture should be deducted from the cost of the main product. Thus, presentation of sale proceeds of scrap as other income is not correct. Alternatively, sale of manufacturing scrap arising from operations for a manufacturing company could be treated as other operating revenue since the same arises on account of the company's main operating activity.

6. **(a)** Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(i) **Fixed assets -** A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(ii) **Inventory -** The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(iii) **Trade Receivables, including bills receivable -** Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

(i) debts due in respect of which the period of credit has not expired;

(ii) debts due within six months; and

(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(iv) Investments - The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(v) Secured Loans - Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

(vi) Provision of Taxation - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(vii) Other Liabilities - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(viii) Insurance - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(ix) Contingent Liabilities - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

(b) Provision of Depreciation : Section 123(1) of the Companies Act, 2013 provides that dividend cannot be declared or paid by a company for any financial year except out of profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Section 123(2), or out of the profits or the company for any previous financial year or years arrived at after providing for depreciation in the manner aforementioned and remaining undistributed, or out of both. Further, it is the duty of auditor to check whether the depreciation was provided according to provision of AS 10 / IND AS 16/Schedule II to the Act.

In the instant case, R Limited is in the practice of maintaining consistent dividend payment over a minimum of 15%. Due to bad financial condition, company has not provided for dividend for the year 2019-20. In addition to this management has also taken decision to charge 65% of the depreciation in the statement of Profit and Loss whereas 35% of the depreciation amount kept in a separate account code in the Balance Sheet – 'Debit Balances Adjustable against Revenue Account'.

Contention of management that it would be in fair practice of accounting where the depreciation of asset is charged before the expiry of the life of assets and the amount parked in asset code would unfailingly be adjusted to revenue before the close of next financial year is not tenable.

The practice of the company in not charging the depreciation and accumulating 35% of it in a debit balance for being written of in the next year is not an acceptable accounting treatment. If dividend is declared in such situation, it would mean payment out of capital.

Therefore, the auditor of the company should ensure the compliance of provisions of section 123 and Schedule II. In case the management does not comply with the provisions and does not charge the 100% depreciation, the auditor of the company should discuss and suggest the correct treatment to the management and if the management refuses to correct, the auditor should qualify his report accordingly.

(c) According to SA-200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.

Audit Risk has two components namely: Risk of material Misstatement and Detection Risk.

The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement x Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components namely Inherent risk and Control risk.

The relationship can be defined as

Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. 40% X 25 % = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures were applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows:

Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

or

(c) Peer Review Report of Reviewer: After completing the on-site Review, the Peer Reviewer, before making his Report to the Board, **shall communicate his findings in the Preliminary Report to the Practice Unit** if in his opinion, the systems and procedures are deficient or non-compliant with reference to any matter that has been noticed by him or if there are other matters where he wants to seek clarification.

The Practice Unit shall within 15 days after the date of receipt of the findings, make any submissions or representations, in writing to the Reviewer. (i.e. Response to the Preliminary Report).

At the end of an on-site Review if the Reviewer is satisfied with the reply received from the Practice Unit, he shall submit a Peer Review Report to the Board along with his initial findings, response by the Practice Unit and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

In case the Reviewer is of the opinion that the response by the Practice Unit is not satisfactory, the Reviewer shall accordingly submit a modified Report to the Board incorporating his reasons for the same. The Reviewer shall also submit initial findings **(i.e. Preliminary Report),** response by the Practice Unit **(Response to Preliminary Report)** and the manner in which the responses have been dealt with. A copy of the report shall also be forwarded to the Practice Unit.

In case of a modified report, The Board shall order for a **"Follow On"** Review after a period of one year from the date of issue of report as mentioned above. If the Board so decides, the period of one year may be reduced but shall not be less than six months from the date of issue of the report.

In the instant case, in view of peer reviewer systems and procedures in ABC & Co. LLP are deficient, therefore, peer reviewer should not submit the report directly to the Board. Thus, contention of ABC & Co. LLP is correct.