Test Series: October 2022

**MOCK TEST PAPER 2**

**INTERMEDIATE: GROUP – II**

**PAPER – 6: AUDITING AND ASSURANCE**

**SUGGESTED ANSWERS / HINTS**

**Division A-Multiple Choice Questions**

**Case Scenario 1**

| Question No. | Answer |
|---|---|
| 1.1 | **(c)** Babita considers that such a document is in nature of an internal control questionnaire for evaluating internal control over capital items. |
| 1.2 | **(c)** Auditors were trying to understand control environment of the company. |
| 1.3 | **(b)** Vouching |
| 1.4 | **(b)** Written Representation |
| 1.5 | **(d)** Babita is of the view that draft in Box E relates to significant matter identified during course of audit and it contains how the same was addressed. Therefore, its inclusion under heading "Key Audit Matters" is proper. |

**Case Scenario 2**

| Question No. | Answer |
|---|---|
| 2.1 | **(a)** Discount on Bills purchased |
| 2.2 | **(c)** The engagement team is evaluating internal control over advances. |
| 2.3 | **(a)** The branch has correctly classified account as NPA and has rightly made provisioning and reversal of unrealized income in this regard. Uttar Pradesh government guarantee has no effect on provisioning and income recognition. |
| 2.4 | **(b)** In CBS environment, in most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management. |
| 2.5 | **(d)** All documents stated at P, Q, R and S form part of audit documentation. |

**General MCQ's**

1. **Option (c)**
2. **Option (d)**
3. **Option (b)**
4. **Option (c)**
5. **Option (b)**
6. **Option (b)**
7. **Option (d)**
8. **Option (a)**
9. **Option (c)**
10. **Option (b)**

## Division B - Descriptive Answers

1. **(i) Incorrect:** Integrity requires an auditor to be straight forward and honest in all professional and business relationships. It implies fair dealing and truthfulness. Confidentiality principle requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

   **(ii) Correct:** Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit, new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

   **(iii) Incorrect:** Checklist is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. Internal control questionnaire is a comprehensive series of questions concerning internal control. The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.

   **(iv) Incorrect:** The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

   **(v) Incorrect:** Stratification means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. Systematic sampling is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

   **(vi) Incorrect:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", 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.

   **(vii) Incorrect:** Audit evidence obtained directly by the auditor (for **example**, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

   **(viii) Incorrect**: Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable

2. **(a)** The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

   **The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:**

   (1) Adherence to professional standards and regulatory and legal requirements;

   (2) Whether the quality control system has been appropriately designed and effectively

implemented; and

(3) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

**(b)** For the purpose of audit programme construction, CA X should keep in mind the following points:

(1) Stay within the scope and limitation of the assignment.

(2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

(3) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

(4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(5) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.

(6) Consider all possibilities of error.

(7) Co-ordinate the procedures to be applied to related items.

**(c) The Entity's Risk Assessment Process– Component of Control Environment**

The auditor shall obtain an understanding of whether the entity has a process for:

(a) Identifying business risks relevant to financial reporting objectives;

(b) Estimating the significance of the risks;

(c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks.

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

**(d)** (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.

**3**. **(a)** In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

(a) Whether the risk is a risk of fraud;

(b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;

(c) The complexity of transactions;

(d) Whether the risk involves significant transactions with related parties;

(e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

**(b)** 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. Also,

(1) 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.

(2) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.

(3) 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.

Therefore, the company, ABC Ltd. has not complied with the above provisions of the Companies Act, 2013.

**(c)** General IT Controls are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

**Program Change**

**Objective:** To ensure that modified systems continue to meet financial reporting objectives.

**Activities:**

- Change Management Process – definition, roles & responsibilities
- Change Requests – record, manage, track
- Making Changes – analyze, design, develop
- Test Changes – test plan, test cases, UAT
- Apply Changes in Production
- Emergency & Minor Changes
- Documentation – user/technical manuals
- User Training

**(d)** As per Section 139(8), any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor General of India, be filled by the Board of Directors within 30 days. If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days. It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.

**4. (a) Matters to be included as per CARO, 2020 :**

**Inventory**

Clause (ii)

(a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

(b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

**Deposits accepted by company or amounts which are deemed to be deposits**

Clause (v)

In respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;

**(b) The statement is not correct.**

The securities premium account may be applied by the Company for the following purposes:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

**(c) The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices.**

The value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts.

- The auditor should:
  - Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land;

- o Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- o The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

**To verify whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements**

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.
- In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.
- In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

**5. (a)** 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.
4. CA Amar should consider the above before using the work of the management's expert.

**(b)** **Emphasis of Matter Paragraph** is a paragraph included in the auditor's report that refers to a matter appropriately presented and disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to the user's understanding of the financial statements.

**Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.**

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

**(c) (i) Fee from Students :-**

1. 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.
2. 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.
3. 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 that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
5. See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
6. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
7. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

**(ii) Other Receipts/Grants & Donations :-**

1. Verify rental income from landed property with the rent rolls, etc.
2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
3. Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

**6. (a) As per the guidelines, Agricultural Advances are of two types:**

(1) Agricultural Advances for "long duration" crops; and

(2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

**(b) Hypothecation:**

The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

**Assignment:**

Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him.

**(c) The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:**

Government Audit is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity ,made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future action by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES of the Govt Audit are :

1. Accounting for Public Funds: It serves as a mechanism or process for public accounting of government funds.
2. Appraisal of Govt. Policies: It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
3. Corrective Actions: Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
4. Administrative Accountability: The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

**(d)** While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. The auditor can perform the following procedures to ensure the same.

- Trace a few transactions from inception to completion. (Examination in depth)
- E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
- If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

**(e)** Rent expense can be verified by:

- Obtaining a month wise expense schedule along with the rent agreements.
- Verifying if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
- Giving specific consideration to the escalation clause in the agreement to verify if the rent was required to be recorded on a straightline basis during the period under audit.
- Also, verifying if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity