

MOCK TEST PAPER 1
INTERMEDIATE (NEW): GROUP – II
PAPER – 6: AUDITING AND ASSURANCE
SUGGESTED ANSWERS / HINTS
Division A-Multiple Choice Questions

Case Scenario 1

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

Case Scenario 2

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

General MCQs

1. (c)
2. (c)
3. (c)
4. (d)
5. (c)

Division B -Descriptive Answers

1. (i) **Incorrect:** 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) **Correct:** The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not and ensure that a material item is disclosed separately and distinctly.
- (iii) **Incorrect:** The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

- (iv) **Incorrect:** As per section 140(2) of the Companies Act, 2013, 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 ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar.
 - (v) **Incorrect:** The existence of a Satisfactory Control environment can be a positive factor when an auditor assesses the risk of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory Control environment is not an absolute deterrent to fraud.
 - (vi) **Incorrect:** Section 139(6) of the Companies Act, 2013 lays down that the first auditor of a company shall be appointed by the Board of Directors within 30 days from the date of registration of the company. In view of the above, the appointment of first auditor made by the managing director is in violation of the provisions of the Companies Act, 2013
 - (vii) **Incorrect:** NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either on an accrual basis or cash basis.
 - (viii) **Incorrect:** There are basically four types of audit tests that should be used in an automated environment. They are inquiry, observation, inspection and re-performance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.
2. (a) The person conducting the audit should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:
- (i) the accounts have been drawn up with reference to entries in the books of account;
 - (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
 - (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
 - (iv) the information conveyed by the statements is clear and unambiguous;
 - (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
 - (vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.
- (b) It is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.
- He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where

undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

- (c) In establishing the overall audit strategy, the auditor shall:
- (a) Identify the characteristics of the engagement that define its scope;
 - (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
 - (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
 - (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
 - (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement.
- (d) **Funded** loans are those loans where there is an actual transfer of funds from the bank to the borrower.

Advances comprise of funded amounts by way of:

- Term loans :-
 - Cash credits, Overdrafts, Demand Loans
 - Bills Discounted and Purchased
 - Participation on Risk Sharing basis
 - Interest-bearing Staff Loans
3. (a) Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:
- ◆ The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.

- ◆ The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
 - ◆ An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
 - ◆ In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
 - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
 - Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315.
- (b) **Understanding of the Company's Automated Environment:** Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment
- Information systems being used (one or more application systems and what they are)
 - their purpose (financial and non-financial)
 - Location of IT systems - local vs global
 - Architecture (desktop based, client-server, web application, cloud based)
 - Version (functions and risks could vary in different versions of same application)
 - Interfaces within systems (in case multiple systems exist)
 - In-house vs Packaged
 - Outsourced activities (IT maintenance and support)
 - Key persons (CIO, CISO, Administrators)
- (c) (i) **Appointment of First Auditor of a Government Company:** Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.
- In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.
- Appointment of First Auditor of a Non-Government Company:** As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company,

shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

- (ii) **Appointment of Subsequent Auditor of a Government Company:** As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Appointment of Subsequent Auditor of a Non-Government Company: As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

4. (a) **Goods Lying with Third Party:** The auditor should check that the materiality of the item under this caption included in inventories.
- (i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.
 - (ii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.
 - (iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.
 - (iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.
 - (v) The excise gate pass, entry in such records, information in returns, be also cross-verified.
 - (vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.
 - (vii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.
 - (viii) Evaluate condition of goods and see whether adequate provision has been made.
 - (ix) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.
 - (x) Ensure that the goods have been included in the closing inventory though lying with third party.

- (b) **Audit Sampling:** As per SA 530 on “Audit Sampling”, the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

- (c) **Division of Internal Control into Components:** The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity’s internal control may affect the audit:

- (i) The control environment;
- (ii) The entity’s risk assessment process;
- (iii) Monitoring of controls.
- (iv) Control activities; and
- (v) The information system, including the related business processes, relevant to financial reporting, and communication;

- (d) **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.

5. (a) **Analytical Review Procedures:** The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

- (i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;
 - (ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;
 - (iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;
 - (iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;
 - (v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;
 - (vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.
- (b)** Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:
- (a) to avoid incidence of income-tax or other taxes;
 - (b) for declaring a dividend when there are insufficient profits;
 - (c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and
 - (d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.
- (c)** **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;

In view of the above clause, the auditor would report that funds raised by the company for expansion and diversification of business have not been used for the said purpose rather the company has utilised these funds for repayment of long term loans and advance.

- (d) Specific Evaluations by the auditor:** The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

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.

6. (a) **Classification as NPA** should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Sub-standard assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:	Provision required						
<ul style="list-style-type: none"> ◆ Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months. 	15%						
<ul style="list-style-type: none"> ◆ Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months. 	Secured+ Unsecured						
<ul style="list-style-type: none"> ◆ Sub-categories: <ul style="list-style-type: none"> Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3) 	<table style="width: 100%; border: none;"> <tr> <td style="width: 50%;">25%</td> <td style="width: 50%;">+ 100%</td> </tr> <tr> <td>40%</td> <td>+ 100%</td> </tr> <tr> <td>100%</td> <td>+ 100%</td> </tr> </table>	25%	+ 100%	40%	+ 100%	100%	+ 100%
25%	+ 100%						
40%	+ 100%						
100%	+ 100%						
<ul style="list-style-type: none"> ◆ Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. 	100%						

(b) **AUDIT OF HOSPITAL**

The important points involved in such an audit are stated below-

- (i) **Register of patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
- (ii) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For eg. copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills etc.
- (iii) **Income from Investments, Rent etc.:** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends and interest on securities have been collected.
- (iv) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (v) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown

by the Subscription Register and the amount collected and that still outstanding).

- (vi) **Authorisation and sanctions:** Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorised.
 - (vii) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
 - (viii) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
 - (ix) **Internal Check:** Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
 - (x) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
 - (xi) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
 - (xii) **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.
 - (xiii) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.
- (c) **While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:**
- (i) Whether the expenditure pertained to current period under audit;
 - (ii) Whether the expenditure qualified as a revenue and not capital expenditure;
 - (iii) Whether the expenditure had a valid supporting like travel tickets, insurance policy, third party invoice etc.;
 - (iv) Whether the expenditure has been classified under the correct expense head;
 - (v) Whether the expenditure was authorised as per the delegation of authority matrix;
 - (vi) Whether the expenditure was in relation to the entity's business and not a personal expenditure
- (d) **Determining Key Audit Matters:** As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:
- (i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
 - (ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
 - (iii) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

- (e) **Exceptions to the rule – Audit Against Propriety:** Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
- (i) the amount of expenditure involved is insignificant; or
 - (ii) a claim for the amount could be enforced in a Court of law; or
 - (iii) the expenditure is in pursuance of a recognised policy or custom; and
 - (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.