

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

Case Scenario 2

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

General MCQs

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

Division B -Descriptive Answers

1. (i) **Incorrect:** As per SA 240 the primary responsibility for the prevention and detection of fraud rests with management. An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

- (ii) **Incorrect:** 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.
 - (iii) **Incorrect:** The cost audit shall be conducted by a Cost Accountant who shall be appointed by the Board of such remuneration as may be determined by the members in such manner as may be prescribed. It may be noted that no person appointed under section 139 as an auditor of the company shall be appointed for conducting the audit of cost records.
 - (iv) **Incorrect:** The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.
 - (v) **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 an accrual basis or cash basis.
 - (vi) **Correct:** As per AS 26, Intangible Assets, internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.
 - (vii) **Incorrect:** The person who is controlling the trade receivables should ensure that proper accounting entries have been passed by crediting respective trade receivables account. The balance of cheque in hand should be disclosed along with the cash and bank balances in the financial statements.
 - (viii) **Incorrect:** When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall indicate that the auditor's opinion is not modified in respect of the matter emphasized. Such a paragraph shall refer only to information presented or disclosed in the financial statements. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.
2. (a) (i) **Assertions about transactions and events for the period relating to PPE :**
- (1) Occurrence—transactions and events relating to PPE have been recorded, have occurred and pertain to the entity.
 - (2) Completeness—all transactions and events relating to PPE that should have been recorded have been recorded.
 - (3) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (4) Cut-off—transactions and events have been recorded in the correct accounting period.
 - (5) Classification—transactions and events have been recorded in the proper accounts.
- (ii) **The specific assertions are as follows:**
- (1) the firm owns the plant and machinery;
 - (2) the historical cost of plant and machinery is Rs. 4 lacs;
 - (3) the plant and machinery physically exists;
 - (4) the asset is being utilised in the business of the company productively;

- (5) total charge of depreciation on this asset is Rs. 1,66,000 to date on which Rs. 26,000 relates to the year in respect of which the accounts are drawn up; and
- (6) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

(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) "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

- (i) acquiring knowledge of the client's accounting systems, policies and internal control procedures;
- (ii) establishing the expected degree of reliance to be placed on internal control;
- (iii) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(iv) coordinating the work to be performed.

3. (a) **Reporting to the Central Government-** As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of Rs. 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.

The manner of reporting the matter to the Central Government is as follows:

- (1) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;
- (2) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;
- (3) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
- (4) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;
- (5) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
- (6) the report shall be in the form of a statement as specified in Form ADT-4.

The auditor is also required to report under **clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 [CARO, 2016]**, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

- (b) **Evaluating the Operating Effectiveness of Controls:** When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

- (i) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- (ii) Additional tests of controls are necessary; or
- (iii) The potential risks of misstatement need to be addressed using substantive procedures.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

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

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

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

- (d) **Ownership of Working Papers:** As per SA 230 "Audit Documentation", working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is not required to provide the management/ clients or other auditors' access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

From above, it is clear that working papers of the branch auditor are his property only and neither the Principal auditor nor management has right to access that. Therefore, statement given in the question is incorrect.

4. (a) Board of Directors of "XYZ Ltd" cannot remove the auditors in Board meeting. According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014-
- i. The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.
 - ii. The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
 - iii. The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.
 - iv. 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.

- (b) No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

- (i) the said asset is identifiable;
 - (ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;
 - (iii) it is probable that future economic benefits associated with the asset will flow to the entity;
 - (iv) the cost of the item can be measured reliably.
- (c) 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:
- (1) to avoid incidence of income-tax or other taxes;
 - (2) for declaring a dividend when there are insufficient profits;
 - (3) 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
 - (4) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

- (i) inflating or suppressing purchases and expenses;
 - (ii) inflating or suppressing sales and other items of income,
 - (iii) inflating or deflating the value of closing inventory;
 - (iv) failing to adjust outstanding liabilities or prepaid expenses; and
 - (v) charging items of capital expenditure to revenue or by capitalising revenue expenses.
- (d) 1. **Clause (iii) of paragraph 3 of CARO, 2016 states**
- Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,
- (i) Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
 - (ii) Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
 - (iii) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
2. Further, Clause (v) of paragraph 3 of CARO, 2016 states in case the company has accepted deposits,
- (i) whether the directives issued by the Reserve Bank of India and the provisions of sections

73 to 76 or any: ether relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated;

- (ii) 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?

In the given situation, M Ltd. has given certain loans to related parties and also has accepted certain deposits. Thus, the auditor is required to report the same as per clause (iii) and (v) of Paragraph 3 of CARO, 2016.

5. (a) The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:
- (1) Obtaining an understanding of the methods used by management in determining segment information. Further,
 - (i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
 - (ii) Where appropriate, testing the application of such methods; and
 - (2) Performing analytical procedures or other audit procedures appropriate in the circumstances.
- (b) The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—
- (i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the **audit against 'rules and orders'**.
 - (ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the **audit of sanctions**.
 - (iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as **audit against provision of funds**.
 - (iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as **propriety audit**.
 - (v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the **performance audit**.
- (c) The following are the purpose of Audit documentation:
- 1. Assisting the engagement team to plan and perform the audit.
 - 2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
 - 3. Enabling the engagement team to be accountable for its work.
 - 4. Retaining a record of matters of continuing significance to future audits.
 - 5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
 - 6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory

or other requirements.

(d) With respect to sales of the client entity, the auditor is required to ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

- Whether disclosure of sales in respect of each class of goods has been made.
- Whether revenue from operations is disclosed separately in the notes as revenue arising from:
 - Sale of products (including excise duty)
 - Sale of services
 - Other operating revenues.
- Whether brokerage and discount on sales other than usual trade discount has been disclosed.
- Whether the transactions with related parties are appropriately disclosed in notes to accounts.

6. (a) (i) **Data Processing:** Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

(ii) **ERP (Enterprise Resource Planning):**

A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.

(iii) **General IT Control:** Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.

(iv) **Automated:** A task or activity that is routinely performed by a computer system and does not require manual effort.

(v) **Direct Data Change:** A backend modification that is made directly to data that is stored in a database bypassing business rules built-in to a business application software.

(b) 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.

Or

- (c) The **audit programme** should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.
- (i) **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
 - (ii) **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
 - (iii) **Ear-marked Funds:** Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
 - (iv) **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.
 - (v) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.
 - (vi) **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
 - (vii) **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis- investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
 - (viii) **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
 - (ix) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.
 - (x) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.
 - (xi) **Programme and Project Expenses:** Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
 - (xii) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.
- (d) There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks	Regional Rural Banks
Co-operative Banks.	Payment Banks.
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks.

1. **Commercial banks** are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-

- (a) accepting deposits and
 - (b) granting advances.
2. **Regional Rural Banks** known as **RRBs** are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. **Examples are :-** *Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank , etc.*
 3. **Co-operative Banks** function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. **Examples are :-** *The Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit , etc.*
 4. **Payments Banks** are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However , customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards , Internet-banking & Mobilebanking. **Examples are :-** *Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.*
 5. **Development Banks** had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. **Examples are:-** *Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.*
 6. **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and **unorganised** sectors like small marginal farmers, small & micro business units, etc. **Examples are:-** *Equitas Small Finance Bank , AU Small Finance Bank , etc.*
- (e) **Disclosure for each class of Contingent Liability:** From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.
- (i) A brief description of the nature of the contingent liability and where practicable.
 - (ii) An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
 - (iii) Indication of the uncertainty relating to outflow.
 - (iv) The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.