Test Series: March, 2016

MOCK TEST PAPER – 2

INTERMEDIATE (IPC): GROUP – II

PAPER – 6: AUDITING AND ASSURANCE

SUGGESTED ANSWERS / HINTS

1. (a) **Matters indicating Auditor about Non-Compliance with Laws and Regulations by Management:** As per SA 250 on "Consideration of Laws and Regulation in an Audit of Financial Statements", the following are examples or matters indicating to the auditor about non-compliance with laws and regulations by management-

(i) Investigations by regulatory organisations and government departments or payment of fines or penalties.

(ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees.

(iii) Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.

(iv) Purchasing at prices significantly above or below market price.

(v) Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.

(vi) Unusual payments towards legal and retainership fees.

(vii) Unusual transactions with companies registered in tax havens.

(viii) Payments for goods or services made other than to the country from which the goods or services originated.

(ix) Payments without proper exchange control documentation.

(x) Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.

(xi) Unauthorised transactions or improperly recorded transactions.

(xii) Adverse media comment.

(b) **Disclosure of Accounting Policies:** The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements.

The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by some cases.

The purpose of AS 1 is to promote better understanding of financial statements by establishing through an accounting standard and the disclosure of significant accounting policies and the manner in which such accounting policies are disclosed in the financial statements.

Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes which form part of financial statements.

Any change in accounting policy, which has a material effect, should be disclosed. The amount by which any item is in the financial statement is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies, which has not material effect on the financial statements for the current period, which is reasonably expected to have material effect in latter periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

(c) Guidance Notes: 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

(d) **Inquiry – Audit Procedure to Obtain Audit Evidence:** Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

2. (i) **Incorrect:** As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.

(ii) **Incorrect:** As per Schedule III to the Companies Act, 2013, a company shall disclose by way of notes additional information regarding aggregate expenditure and income for an item which exceeds 1% of the revenue from the operation or Rs. 1,00,000 whichever is higher.

(iii) **Correct:** As per section 139(10) of the Companies Act, 2013, where at any AGM, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

(iv) **Correct:** The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it.

(v) **Incorrect:** As per the objectives given in SA 570 "Going Concern", the auditor is required to obtain sufficient appropriate audit evidence about the appropriateness of management's use of going concern assumption in the preparation and presentation of the financial statements.

(vi) Correct: According to section 53 of the Companies Act, 2013, a company shall not issue shares at a discount. However, exception has been given in the case of an issue of sweat equity shares.

(vii) Incorrect: When a transaction has been omitted either wholly or partially it is known as "Error of Omission" whereas "Error of Commission" is where a transaction has been mis-recorded either wholly or partially.

(viii) Incorrect: Section 138 of the Companies Act, 2013 deals with the provisions relating to internal audit.

(ix) Correct: Overall objective of audit does not change in Computer Information System (CIS) environment. But the use of computer changes the processing and storage, retrieval and communication of financial information.

(x) Correct: As per section 182 of the Companies Act, 2013, a company, other than a government company, which has been in existence for three or more financial years can contribute to any political party an amount not exceeding 7½ % of average net profit during the three immediately preceding financial years which works out to Rs. 7.5 lakh in the given case. Therefore, contribution of Rs. 5 lakh is within the limit prescribed.

3. (a) Sale of Scrap:

(i) Review the internal control as regards generation, storage and disposal of scrap.

(ii) Check whether the organization is maintaining reasonable record for generation of Scrap.

(iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.

(iv) Check the rates at which scrap has been sold and compare the rate with previous year.

(v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.

(vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.

(vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

(b) Advertisement Expenses:

(i) Verify the bill/invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.

(ii) See that advertisement relates to client's business.

(iii) Inspect the receipt issued by the agency.

(iv) Ascertain the nature of expenditure – revenue deferred and see that it has been recorded properly.

(v) Ascertain the period for which payment is made and see that pre-paid is carried forward to balance sheet.

(vi) Compare the statement of account with the ledger account.

(vii) See that all outstanding advertisement bills have been provided for.

(c) Assets Acquired on Lease:

(i) Examine the terms and conditions of the lease deed.

(ii) If a part of the leasehold property has been sublet, examine the tenant's agreement.

(iii) Verify relevant document to check the cost of property.

(1) In case of acquisition of an asset is on operating lease, lease payment should be recognized as an expense in the Statement of Profit and Loss on a straight line basis over the lease term;

(2) In case of acquisition of an asset is on finance lease, ensure all the substantial risks and rewards to ownership are transferred, considering the indication as prescribed in AS-19, the lessee should recognize the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased assets at the inception of the lease. Ensure contingent rents are recognized as expense in the statement of profit & loss for the period in case of Finance lease.

(iv) Ensure assets acquired under finance lease are segregated from the assets owned.

(v) Ensure that the assets under lease have been properly disclosed as per requirement of Schedule III to the Companies Act, 2013.

(d) Investment in Shares and Debentures of Subsidiary:

(i) The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc.

(ii) All the particulars entered in the schedule should be verified with the relevant account in the General Ledger.

(iii) The auditor should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

(iv) The provisions contained in Part I of Schedule III to the Companies Act, 2013 requires that the shares held in a subsidiary should be shown separately.

(v) The shares or debentures of a subsidiary are valued at cost.

(vi) If the subsidiary has suffered a loss, then a provision for the proportionate part of the loss should be made in the accounts of the holding company.

4. (a) Identification of Significant Related Party Transaction Outside Business: As per SA 550 on "Related Parties", for identified significant related party transactions outside the entity's normal course of business, the auditor shall-

(i) Inspect the underlying contracts or agreements, if any, and evaluate whether:

(1) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

(2) The terms of the transactions are consistent with management's explanations; and

(3) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

(ii) Obtain audit evidence that the transactions have been appropriately authorized and approved.

(b) Factors Influencing Degree of Estimation Uncertainty: According to SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as-

(i) The extent to which the accounting estimate depends on judgment.

(ii) The sensitivity of the accounting estimate to changes in assumptions.

(iii) The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).

(iv) The length of the forecast period, and the relevance of data drawn from past events to forecast future events.

(v) The availability of reliable data from external sources.

(vi) The extent to which the accounting estimate is based on observable or unobservable inputs.

(c) Factors Influencing Auditor's Decision on Whether to Use an Auditor's Expert when Management has used a Management's Expert: SA 620 "Using the Work of an Auditor's Expert" states that when management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may be influenced by such factors as-

(i) The nature, scope and objectives of the management's expert's work.

(ii) Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.

(iii) The extent to which management can exercise control or influence over the work of the management's expert.

(iv) The management's expert's competence and capabilities.

(v) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.

(vi) Any controls within the entity over the management's expert's work.

5. (a) Limitations of Internal Control system: Internal control system can provide only reasonable but not absolute assurance that its objective relating to prevention and detection of errors/frauds, safeguarding of assets etc., are achieved. This is because it suffers from some inherent limitations, such as:-

(i) Management's consideration that cost of an internal control does not exceeds the expected benefits.

(ii) Most controls do not tend to be directed at unusual transactions.

(iii) The potential of human error due to carelessness, misjudgment and misunderstanding of instructions.

(iv) The possibility that control may be circumvented through collusion with employees or outsiders.

(v) The possibility that a person responsible for exercising control may abuse that authority.

(vi) Compliance with procedures may deteriorate because the procedures becoming inadequate due to change in condition.

(vii) Manipulation by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

(viii) Inherent limitations of Audit.

(b) Comment on Matters Contained under Section 143(1) of the Companies Act, 2013: Section 143(1) of the Companies Act, 2013 deals with duties of an auditor requiring him to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor are relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of X Ltd. is correct in non-reporting on the matters specified in section 143(1) of the Companies Act, 2013.

(c) Audit of an Educational Institution: The special steps involved in the audit of an educational institution are the following-

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

6. (a) Examining a Voucher: The essential points to be borne in mind while examining a voucher are-

(i) that the date of the voucher falls within the accounting period;

(ii) that the voucher is made out in the client's name;

(iii) that the voucher is duly authorised;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

(b) Utilisation of Securities Premium: Section 52 of the Companies Act, 2013 deals with creation of Securities Premium Account for premium received on issues of shares and its application thereon. Section 52(2) lays down that the securities premium account may be applied by the company-

(i) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;

(ii) in writing off the preliminary expenses of the company;

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

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

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

Thus, it is clear from the above that securities premium can be utilised only for specific purposes. Further, section 123 of the Companies Act, 2013 also specifies the sources from which dividends can be paid and requires the same to be only paid out of current/past profits or any other free reserve.

Hence, declaration of dividends out of securities premium is not proper and, consequently, the auditor shall have to qualify the audit report.

(c) Audit of Stores and Inventories: Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out. The aim is also to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

The audit of purchase of stores is conducted in the same manner as audit of expenditure, namely, that these are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority. The auditor has to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

Accounts of receipts, issues and balances are checked regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

7. (a) Audit Note Book: An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. Audit note books form part of audit working papers and for each year a fresh audit note book is maintained. In case an auditor classifies his working paper into permanent and current, then audit note book shall form part of the current file. It is in any case a part of the permanent record of the auditor available for reference later on, if required.

The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily. It is also used for recording the various queries raised in the course of the work and their state of disposal. In respect of disposed queries, explanation obtained and evidence seen would be recorded in the said book, while queries remaining undisposed off would be noted for follow up.

(b) Self-Revealing Errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts.

A few illustrations of such errors are given hereunder, showing how they become apparent-

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(ii)	Wrong totaling of the Purchase Register.	Control Account (e.g., the Sundry Creditors Account) balances and the aggregate of the balances in the personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

(c) Companies Exempted from Reporting under CARO, 2015: The Companies (Auditor's Report) Order, 2015 applies to every company including a foreign company. However, the Order specifically exempts the following class of companies-

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;

(ii) an insurance company as defined under the Insurance Act,1938;

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act;

(v) a small company as defined under clause (85) of section 2 of the Companies Act; and

(vi) a private limited company with a paid up capital and reserves not more than Rs. 50 lakh and which does not have loan outstanding exceeding Rs. 25 lakh from any bank or financial institution and does not have a turnover exceeding Rs. 5 crore at any point of time during the financial year.

(d) Verification procedure for Splitting of one share of the face value of Rs. 10 into 10 shares of Re. 1 each:

(i) Confirm that alteration was authorised by articles.

(ii) Verify the minutes of the Board meeting and ordinary resolution passed in the general meeting in which the approval of members is obtained.

(iii) Verify also with reference to requisite Form required to be filed with the ROC.

(iv) Verify that alteration had been effected in copies of Memorandum Articles, etc.

(v) Verify that proper accounting entries have been passed. Register of members may also be checked to see that the necessary alteration have been effected therein.

(e) Assertions used by Auditor to Consider Potential Misstatements about Presentation and Disclosure at the Period End: According to SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the assertions used by the auditor to consider the different types of potential misstatements that may occur about presentation and disclosure at the period end are-

(i) Occurrence and rights and obligations — disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) Completeness — all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability — financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation — financial and other information are disclosed fairly and at appropriate amounts.