

**MOCK TEST PAPER – 1**  
**INTERMEDIATE (IPC): GROUP – II**  
**PAPER – 6: AUDITING AND ASSURANCE**  
**SUGGESTED ANSWERS / HINTS**

1. (a) **Selection of Audit Sample:** Audit Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population.

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

- (b) **Information which assist the Auditor in accepting and continuing of relationship with Client:** As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:

- (i) The integrity of the principal owners, key management and those charged with governance of the entity;
- (ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- (iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and
- (iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

- (c) **General Factors Influencing Auditor's Judgment about Sufficient and Appropriate Audit Evidence:** In general, the various factors which may influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under-

- (i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.
- (ii) The materiality of the item.
- (iii) The experience gained during previous audits.
- (iv) The results of auditing procedures, including fraud and errors which may have been found.

- (v) The type of information available.
- (vi) The trend indicated by accounting ratios and analysis.

**(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 610 "Using the Work of Internal Auditor", in determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Discussion of fraud risks is such an activity that would not be appropriate to use internal auditors to provide direct assistance. The external auditors may make only inquiries of internal auditors about fraud risks in the organization in accordance with SA 315.

(ii) **Correct:** As per section 141(3)(g) of the Companies Act, 2013, one person companies shall not be included under ceiling limit on holding appointment as auditor of companies.

(iii) **Incorrect:** Emphasis of Matter paragraph is paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

(iv) **Incorrect:** Section 148 of the Companies Act, 2013 deals with the provisions relating to cost audit whereas section 138 of the Companies Act, 2013 deals with the provisions relating to internal audit.

(v) **Incorrect:** CARO,2016 is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein.

(vi) **Incorrect:** Appropriateness is the measure of the quality of audit evidence. On the other hand, sufficiency is the measure of the quantity of audit evidence.

(vii) **Correct:** Narrative Record is a complete and exhaustive description of the system as found in operation by the auditor.

(viii) Inquiry consists of seeking information of knowledgeable persons, both, financial and non-financial, within the entity or outside the entity.

Observation consists of looking at a process or procedure being performed by others.

(ix) **Incorrect:** As per SA 299 “Responsibility of Joint Auditors”, where the joint auditors are in disagreement with regard to any matter to be covered by the audit report, each one of them should express his own opinion through a separate report.

(x) **Correct:** Section 141(3)(b) of the Companies Act, 2013 evidently excludes an officer or employee of the company to be qualified for appointment as auditor of a company.

**3. (a) Bank Balances:**

- (i) Verify bank balance by reference to bank statements.
- (ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.
- (iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment.
- (iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
- (v) Check the disclosure requirement in the Balance Sheet as per Part I of Schedule III to the Companies Act, 2013 in the case of a company.

**(b) Bills Payable:** These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. Steps involved in their verification are:

- (i) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.
- (ii) Trace all the entries in the Bills Payable Book to the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.
- (iii) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.
- (iv) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.
- (v) Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

**(c) Sale Proceeds of Junk Material**

- (i) Review the internal control on junk material, as regards its generations, storage and disposal & see whether it was properly followed at every stage.
- (ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk material.
- (iii) Review the production and cost records for the determination of the extent of junk material that may arise in a given period.
- (iv) Compare the income from the sale of junk material with the corresponding figures of the preceding three years.
- (v) Check the rates at which different types of junk material have been sold and compare the same with the rates that prevailed in the preceding year.

- (vi) See that all junk material sold has been billed and check the calculations on the invoices.
- (vii) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.
- (viii) Make an overall assessment of the value of the realisation from the sale of junk material as to its reasonableness.

**(d) Assets Abroad:**

- (i) Examine the title deeds of immovable properties abroad.
- (ii) Ensure that the immovable properties abroad have been properly classified and disclosed.
- (iii) Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.
- (iv) Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

**4. (a) Certificate from a Management's Expert:** The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of a management's expert. SA 500 on "Audit Evidence" also states that the preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. It further requires the auditor to evaluate the competence, capabilities and objectivity of that expert; obtain an understanding of the work of that expert; and evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion, to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA 500 before relying upon the certificate obtained by the management from the actuary.

**(b) Matters to be included in the Auditor's Report under CARO, 2016:** The auditor's report on the accounts of a company to which CARO applies shall include a statement on the following matters, namely-

**(i) Fixed Assets-**

- (1) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (2) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (3) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof.

**(ii) As per clause (vii) of CARO, 2016, reporting requirements in respect of statutory dues are :**

- (1) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues

as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

- (2) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).

**(c) Inherent Limitations of Internal Control System:** Internal control 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.

5. **(a) Filling of a Casual Vacancy:** Section 139(8) of the Companies Act, 2013 provides that any casual vacancy in the office of an auditor shall be filled by the Board of Directors within 30 days. However, 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 3 months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

In the present case, the auditor Mr. A resigned and the vacancy had been filled in by Board. But, the vacancy caused by resignation cannot be filled by Board itself, such appointment shall also be approved by the company at general meeting.

The fact that the Mr. A was appointed by Board originally is a matter irrelevant in this situation. If the cause of vacancy is resignation, then the power of appointment shall vest with the general meeting only. As such, the appointment made by Board is invalid.

**(b) Verification of Issue of Bonus Shares:** Section 63 of the Companies Act, 2013 allows a company to issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-

- (i) its free reserves;
- (ii) the securities premium account; or
- (iii) the capital redemption reserve account.

The auditor should ensure that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Further, he should also ensure the compliance of condition for capitalization of profits or reserves for the issuing fully paid-up bonus shares like -

- (i) it is authorised by its articles;
- (ii) it has, on the recommendation of the Board, been authorised in the general meeting of the company;
- (iii) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
- (iv) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
- (v) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;
- (vi) it complies with such conditions as may be prescribed like the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same;
- (vii) the bonus shares shall not be issued in lieu of dividend.

**(c) Audit of Club:** A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 2013 relating to the audit of accounts of companies are also applicable to its audit. The special steps involved in such an audit are stated below -

- (i) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- (ii) Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
- (iii) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- (iv) Check totals of various columns of the Register of members and tally them across.
- (v) See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
- (vi) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
- (vii) Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
- (viii) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- (ix) Vouch purchases of foodstuffs, cigars, wines, etc. and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
- (x) Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.
- (xi) Inspect the share scrips and bonds in respect of investments, check their current values for

disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.

(xii) Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

**6. (a) Applicability of Provisions Related to Rotation of Auditors:** The provisions related to rotation of auditor as provided under section 139(2) of the Companies Act, 2013 are applicable to all listed companies and other class or classes of companies as prescribed under Companies (Audit and Auditors) Rules, 2014.

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

- (i) all unlisted public companies having paid up share capital of Rs. 10 crore or more;
- (ii) all private limited companies having paid up share capital of Rs. 50 crore or more;
- (iii) all companies having public borrowings from financial institutions, banks or public deposits of Rs. 50 crores or more.

**(b) Manner of Rotation of Auditors on Expiry of their Term:** Prescribed manner of rotation of auditors on expiry of their term is given below-

- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
- (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
- (3) For the purpose of the rotation of auditors-
  - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;
  - (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.

The term "same network" includes the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

Further, for the purpose of rotation of auditors, -

- (a) a break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation;
  - (b) if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.

**(c) Reporting under Section 143(3)(f) of the Act :**

**Section 143(3)(f) of the Act states that-**

“The auditor’s report shall also state the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;”

Clause (f) requires the auditor to report "the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company". An auditor’s report may contain matters leading to modifications to the auditor’s opinion or emphasis of matter in the auditor’s report on the financial statements. Such matters may be related to issues which may have an adverse effect on the functioning of the company. The words “observations” or “comments” as appearing in clause (f) of section 143(3) are construed to have the same meaning as referring to “emphasis of matter paragraphs, situations leading to modification in the auditor’s report. Accordingly, the auditor should have made an “observation” or “comment” in the auditor’s report in order to determine the need to report under clause (f) of section 143(3). Therefore, only such "observations" or "comments" of the auditors on financial transactions or matters that have been made by the auditor in the auditor’s report which have an adverse effect on the functioning of the company are required to be reported under this clause. For the sake of clarity, it may be noted that neither the auditor’s observations nor the comments made by him have any adverse effect on the functioning of a company. These observations or comments made by the auditor might contain matters which might have an adverse effect on the functioning of a company.

**7. (a) Disadvantages of the Use of an Audit Programme:**

- (i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on.
- (iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (iv) A hard and fast programme may kill the initiative and innovation of efficient and enterprising assistants.

**(b) Surprise Checks:** Surprise checks are a part of normal audit procedures. An element of surprise can significantly improve the audit effectiveness. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client’s office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client’s staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management’s attention, so that corrective action can be taken at the earliest. Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

**(c) Assertions about classes of transactions and events for the period under audit:** According to SA 315 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit

procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertions used by the auditor about classes of transactions and events for the period under audit may take the following forms-

- (i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
  - (ii) Completeness—all transactions and events that should have been recorded have been recorded.
  - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
  - (iv) Cut-off—transactions and events have been recorded in the correct accounting period.
  - (v) Classification—transactions and events have been recorded in the proper accounts.
- (d) Removal of Auditor Before Expiry of Term:** According to section 140(1) of the Companies Act, 2013, 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 Companies (Audit and Auditors) Rules, 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.

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.

- (e) Objectives of Audit of Local Bodies:** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are-
- (i) reporting on the fairness of the content and presentation of financial statements;
  - (ii) reporting upon the strengths and weaknesses of systems of financial control;
  - (iii) reporting on the adherence to legal and/or administrative requirements;
  - (iv) reporting upon whether value is being fully received on money spent; and
  - (v) detection and prevention of error, fraud and misuse of resources.