ANSWERS

**PART-I MCQs** **30 marks**

**1.** "PQR & Co." is an Audit Firm having partners "Mr. P", "Mr. Q" and "Mr. R", Chartered Accountants. "Mr. P", "Mr. Q" and "Mr. R" are holding appointment as an Auditor in 5, 7 and 9 Companies respectively.

(i) c) 39

(ii) b) 15, 13, 11.

**(iii)** a) It can accept all such audit as it is within the limit of 141(3)(g)

**(iv)** a) It can take audit of 30 private company only out of 45 companies.

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2. **Which of the following is correct?** **2**

**d)** Both (b) and (c)

3. **General IT control that ensure backups, performance monitoring, recovery from failures commonly include controls over** **20** x1 = 20

**c)** Data Center and Network Operations

**4. Which of the following factor should be considered for examining validity of transactions?**

**d)** All of the above

**5. After assembly of audit file, the auditor**

**c)** Shall not delete audit documentation before its retention time period

**6. Pick the odd one**

**d)** Auditor

**7. When joint auditors are appointed, they should**

**b)** Divide the audit work among themselves by mutual discussion

**8. Which of the following is not IT related risk?**

**c)** Sampling Risk

**9. SA Series 500-599 cover the aspects of**

**c)** Audit Evidence

**10. If the professional becomes a witness where the part to litigation is his client, it will result in**

**b)** Advocacy threat

**11. Types of Controls in an Automated Environment**

**d)** All of above

**12. While verifying intangible assets, an auditor would recompute amortization charges and determine whether amortization period is reasonable. The auditor tries to establish by doing it**

**a)** Valuation

**13. Which of the following is the least persuasive type of audit evidence?**

**c)** Carbon copies of sales invoices inspected by the auditor

**14. Following audit procedures are performed by auditor to obtain sufficient appropriate audit evidence**

**d)** Both (b) and (c)

15. **Components of risk of material misstatements are**

**a)** Inherent Risk and Control Risk

**16. A Ltd, is in a highly competitive industry with majority of the competition coming from middle east countries. The company's products have a relatively short life cycle and product development is continuous in order to keep up with competitors.**
**For the inventory account, the assertion upon which most audit efforts should be concentrated is**

**a)** Existence

**17. Audit Plan should be based on**

**a)** Knowledge of client's business

**18. Which of the following section of Companies Act, 2013 deals with requirement of internal audit in companies**

**b)** Section 138

19. **________means evaluation of financial information through analysis of plausible relationships among both financial and non-financial data.**

**b)** Analytical Procedures

20.__________ **is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.**

**d)** Non-Sampling Risk

**21. Which of the following in incorrect w.r.t audit programme**

**c)** An audit programme is a summarized plan

**22. For purposes of the SAs, which of the following meaning attributed to the term "Assertions"**

**a)** Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur**.**

**PART-II Descriptive questions** **70 marks**

**PART-II**

Q1 - Examine with reasons whether the following statements are correct or incorrect. **2x7 = 14**
(Answer any seven out of eight)

(a) In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".
**Incorrect - in some cases there can be join liability**

(b) Generally, applying inquiry in combination with observation gives the most effective and efficient audit evidence.
**Incorrect- Inquiry with inspection gives the best result.**

(c) Pervasive effects on the financial statements are those that, in the auditor's judgment: Are confined to specific elements, accounts or items of the financial statements;
**Incorrect- there are NOT confined to specific element**

(d) A provision is recognised when: An entity has a present obligation (legal or constructive) as a result of a past event; It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and A reliable estimate cannot be made of the amount of the obligation.
**Incorrect- A reliable estimation CAN be made**

(e) The higher the auditor's assessment of the risk of material misstatement, the lower the sample size needs to be
**Incorrect- higher the sample size need to be**

(f) The auditor's lien on client's books and records is unconditional
**Incorrect- it is subject to conditions**

(g) Mr. Aditya, a practicing-chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Sanghvi is the Managing Director, Mr. Aditya believes that his appointment is valid as tax consultant services are not included under section 144.
**Correct - Mr. Aditya who is not the auditor of the company can be appointed as tax consultant. As section 144 is applicable only to the auditor of the company if a CA is appointed as tax consultant even though his father is MD of the company, appointment as Tax consultant would be valid as that is not in the scope of Section 144.**

(h) Registered mortgage is affected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

**Incorrect- its equitable mortgage**

**2.** (a) Discuss the factors that may affect the identification of an appropriate benchmark.

**Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:**

**The elements of the financial statements**

**Example**

**Assets, liabilities, equity, revenue, expenses;**

**Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused**

**Example**

**For the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets**

**The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates; the entity's ownership structure and the way it is financed and the relative volatility of the benchmark.**

**Example**

**If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings);**

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(b) As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted. Discuss 4

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**The use by management of an acceptable financial reporting framework**

**In the preparation of the financial statements**

**And the agreement of**
**management to the premise on**
**which an audit is conducted**
**In order to establish whether the preconditions for an audit are present, the auditor shall:**
**Determine whether the financial reporting framework is acceptable; and**
**Obtain the agreement of management that it acknowledges and understands its responsibility:**
**For the preparation of the financial statements in accordance with the applicable financial reporting framework;**
**For the internal control as management considers necessary; and**
**To provide the auditor with:**
**Access to all information such as records, documentation and other matters;**
**Additional information that the auditor may request from management for the purpose of the audit; and**
**Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.**

(c) Discuss the difference between Internal financial control and internal control over financial reporting.

**IFC - Policies and adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information." auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements**
**ICFR - is required when auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements..**

(d) In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.

**Inherent limitations - other matter**
**In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:**
**Fraud, particularly fraud involving senior management or collusion.**
**The existence and completeness of related party relationships and transactions.**
**The occurrence of non-compliance with laws and regulations.**
**Future events or conditions that may cause an entity to cease to continue as a going concern.**

3. (a) A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management. Discuss the methods for evaluation of internal control.

**Narrative records**
**This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases where no formal control system is in operation and would be more suited to small business.**
**The basic disadvantages of narrative records are:**
**To comprehend the system in operation is quite difficult.**
**To identify weaknesses or gaps in the system.**
**To incorporate changes arising on account of reshuffling of manpower, etc.**
**Check list**
**This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control.**
**ICQ -This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.**
**An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.**
**The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.**
**Flow chart -It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.**

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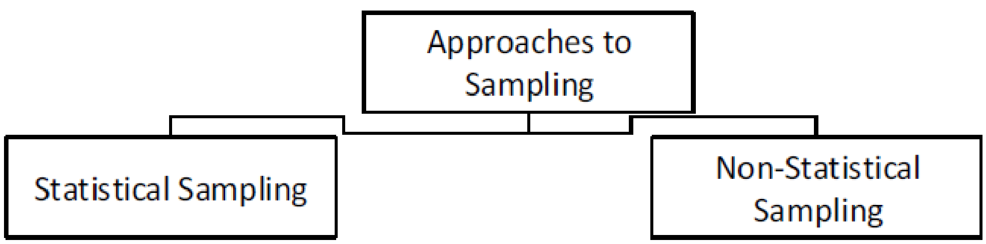
(b) Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

**Audit sampling enables the auditor to obtain and evaluate audit evidence about some**
**characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.**
**The decision whether to use a statistical or non-statistical sampling approach is a matter**
**for the auditor's judgment; however, sample size is not a valid criterion to distinguish**
**between statistical and non-statistical approaches.**
**Sample must be representative**
**Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough**
**to provide statistically meaningful results.**

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(c) Discuss the Analytical Procedures used as Substantive Tests.

**When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:**
**Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;**
**Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;**
**Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or**

**when aggregated with other misstatements, may cause the financial statements to be materially misstated; and**
**Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.**

(d) The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. Explain

**Auditors responsibility for fraud**

**As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.**

**It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention,**

**An auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. As described in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing," owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.**

**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, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.**

4. (a) Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS). In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity,

income, expenses, and disclosures in accordance with the applicable accounting standards. Explain with example stating the relevant assertions involved in this regard. Also, explain financial statement audit. 4

**Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS).**

**A financial statement audit comprises the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the financial statements and related disclosures.**

**In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:**

- **completeness;**
- **cut-off;**
- **existence/ occurrence;**
- **valuation/ measurement;**
- **rights and obligations; and**
- **presentation and disclosure**

**of assets, liabilities, equity, income, expenses, and disclosures in accordance with the applicable accounting standards.**

**For E.g. When we find in the balance sheet, an item under fixed assets reading as**

| Particulars | | Rs. |
|---|---|---|
| Building (at cost) | | 4,00,000 |
| Less: Depreciation till the end of the previous year | 1,40,000 | |
| Depreciation for the year | 20,000 | 1,60,000 |
| | | 2,40,000 |

**The assertions are as follows:**

**(i) The firm owns the Building -Ownership/Right and obligation**

**(ii) The historical cost of Building is Rs. 4 lacs; - Valuation**

**(iii) The Building physically exists; -Existence**

**(iv) Total charge of depreciation on this asset is Rs. 1,60,000 to date on which Rs. 20,000 relates to the year in respect of which the accounts are drawn up; and - Valuation**

(b) At an Annual General Meeting of a listed company, Mr. R a retiring auditor after completing the tenure of five consecutive years of his service claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P, could not be proceeded with, due to Mr. P's death. 4

**as per section 139(10) if no other auditor is appointed at the meeting the existing auditor shall continue.**

**but as per section 139(2) an individual can hold office up to maximum of one term i.e 5 years**

**in this case as R has completed that term there shall be a compulsory cooling period and he can not be re appointed automatically.**

(c) Reserves are amounts appropriated out of profits whereas on the contrary, **provisions are amounts charged against revenue. Discuss explaining the difference between the two and also explain clearly revenue reserve and capital reserve. 3**

**Answer - Reserves are amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.**

**On the contrary, provisions are amounts charged against revenue to provide for:**

- **Renewal or diminution in the value of assets; or**
- **a known liability, the amount whereof could only be estimated and cannot be determined with accuracy; or**
- **a claim which is disputed.**

- **Amounts contributed or transferred from profits to make good the diminution in value of assets due to the fact that some of them have been lost or destroyed as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.**

(d) Discuss the Compliance procedure for trade receivable as a part of sales audit. 3

**Answer -Trade receivable is an essential part of any organisation's balance sheet. Often referred to as debtors, these are monies which are owed to an organisation by a customer.**

- **It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:**
  - **• Only bona fide sales lead to trade receivables.**
  - **• All such sales are made to approved customers.**
  - **• All such sales are recorded.**
  - **• Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.**
  - **• Debtors are collected on time.**

➢ • **Balances are regularly reviewed. A proper system of follow up exists and if necessary, adequate provision for bad debt should be made.**

5. (a) As the statutory auditor of B Ltd. to whom CARO, 2016 is applicable, how would you report in the following situation? Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources. 4

**Clause ii of para 3 of CARO deals with inventory which provides**
**whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account;**
**as only 50% of inventory valued auditor needs to report as per clause ii of CARO -16**

(b)The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of Kapur Industries Ltd. The auditor requests management to provide Banker's certificate in support of fixed deposits whereas management provides only written representation on the matter. Required-Discuss how you would deal as an auditor. 4

**Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.**
**Written representations are requested from those responsible for the preparation and presentation of the financial statements.**
**Although 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. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about Specific assertions.**

(c) Nickson Ltd. is a subsidiary of Ajanta Ltd., whose 20% shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nickson Ltd. appointed Mr. P as statutory auditor for the year 3

**139(7)**

**Notwithstanding anything contained in sub-section (1) or sub-section (5), 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 sixty days from the date of registration of the company and in case the**

**Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; And in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.**

(d)Discuss the audit procedure to obtain audit evidence. 3

Audit procedures to obtain audit evidence can include:

**(i) Inspection**

**(ii) Observation**

**(iii) External Confirmation**

**(iv) Recalculation**

**(v) Reperformance**

**(vi) Analytical Procedures**

**(vii) Inquiry**

6. (a) Discuss the matters which should be specially considered in the audit of accounts of a LLP. 4

**The auditor should get definite instructions in writing as to the work to be performed by him.**
**The auditor should read the LLP agreement & note the following provisions**
**Nature of the business of the LLP.**
**Amount of capital contributed by each partner.**
**Interest – in respect of additional capital contributed.**
**Duration of partnership.**
**Drawings allowed to the partners.**
**Salaries, commission etc. payable to partners.**
**Borrowing powers of the LLP.**
**Rights & duties of partners.**
**Method of settlement of accounts between partners at the time of admission, retirement, admission etc.**
**Any loans advanced by the partners.**
**Profit sharing ratio**
**If partners maintain minute book he shall refer it for any resolution passed regarding the accounts**
**The auditor should mention**
**Whether the records of the firm appear to be correct & reliable.**
**Whether he was able to obtain all information & explanation necessary for his work.**

**Whether any restriction was imposed upon him.**

(b)Describe the audit procedures to be followed by a Statutory Auditor of a bank for audit of contingent liabilities. 4

**The auditor should ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.**

**The auditor should obtain an understanding as to how the Bank computes provision on standard assets and non-performing assets. It will primarily include the basis of the classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. For verification of provision on standard assets, the auditor should verify the loan classification on a sample basis. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balance with the general ledger.**

**The auditor should examine whether by performing re-computation the provisions in respect of standard loans, NPA and NPI comply with the regulatory requirements. The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.**

**The auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961.**

**The other provisions for expenditure should be examined vis a vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.**

(c) Write a short note on "Reversal of Income' 3

**If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.**

**In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.**

**Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).**

**Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired is there are any communications from borrowers pointing out differences in Interest charge, and whether action as justified has beentaken in this regard.**

**On Leased Assets: The finance charge component of finance income (as defined in AS 19 – Leases) on the leased asset which has accrued and was credited to income account before the**

**asset became non-performing, and remaining unrealised, should be reversed or provided for in the current accounting period.**

**On Take-out Finance: In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).**

(d) "Examination of overdue debts, audit classification of society, and reporting the infringement of provisions of the Act are the special features of audit of a co-operative society." Do you agree? 4

**Overdue debts for a period from 6 months to 5 years and more than 5 years will have to be classified and shall have to be reported by an auditor. Overdue debts have far reaching consequences on the working of a credit society. It affects its working capital position. A further analysis of these overdue debts from the viewpoint of chances of recovery will have to be made, and they will have to be classified as good or bad. The auditor will have to ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.**