

**MOCK TEST PAPER – 1**  
**IPCC/PCC: GROUP – II /GROUP – 1**  
**PAPER – 6/2: AUDITING AND ASSURANCE**  
**SUGGESTED ANSWERS/HINTS**

1. (a) **Test Checking in System Based Audit:** System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that:

- (i) All the transactions and information have been recorded,
- (ii) Fraud and errors, if any, in preparing the accounts will be identified,
- (iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,
- (iv) There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above-mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he resorts to actual testing of the system in operation. This he does on a selective basis, i.e., he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth. This approach is adopted in system based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

- (b) The objective of the audit of the financial statements prepared within a framework of recognized accounting policies and practices and relevant statutory requirements if any, is to enable an auditor to express an opinion on such financial statements. As per the requirements of section 227 of the Companies Act, 1956, the Auditor is required to express his opinion on (i) whether books of account as required by law have been kept by the company so far as it appears from the examination of the

books and proper returns adequate for the purpose of audit have been received from branches not visited by them (ii) Whether the accounts give the information required by the act in the manner so required (iii) whether the accounts give a fair view in case of the balance sheet, the state of the companies affairs and in case of the profit and loss account of the profit and loss for the year. The auditor is responsible for forming and expressing his opinion on the financial statements. However, the responsibility for their preparation is that of the management of the enterprise. Management responsibilities include the maintenance of adequate accounting records and internal controls, the selection and application statements do not relieve the management of its responsibilities....

- (c) Sec.224 (5) of the companies Act 1956(the Act) lays down that “the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company”. However, in the case of a government Company, the appointment or reappointment of auditor is governed by the provisions of Section 619 of the Companies Act, 1956. Hence in the case of Public Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India. Thus the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd. is null and void.
- (d) An independent audit whether performed in terms of relevant statutory legislation or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks. Factors which may cause such risk in conducting an audit are discussed below:
  - (i) **Exercising judgement on the part of the auditor:** The auditor’s work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.
  - (ii) **Nature of audit evidence:** The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such evidence may far exceed the benefits.
  - (iii) **Inherent limitations of internal control:** Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite nature that an audit suffers from control risk on account of inherent limitations of internal control risk and detection risk on account

of test nature of audit and judgement and estimates involved in formulating accounting policies.

2. (a)
- (i) Personnel Department should keep record for each employee showing particulars of employment, retirement or dismissal, rates of pay, increment, leave, specimen signatures etc.
  - (ii) Identity cards should be issued to all employees at the time of employment.
  - (iii) Time keeping and attendance recording function should be separated from pay roll preparation.
  - (iv) Overtime should be authorised by a competent official.
  - (v) Preparation of wages and salary bills should be done by members of the staff who are not connected with maintaining a record of their attendance.
  - (vi) Gross pay for each wage period should be compared with the corresponding amount for the previous wage period and differences due to increments, promotions etc. should be reconciled.
  - (vii) Duties of different clerks employed for preparation of wages and salaries bills should be rotated so that the calculations, additions & extensions are not carried out by same clerk every month.
  - (viii) Supervisor authorities should be present at the time of payment to identify the employees.
  - (ix) The system of engaging casual Labourers should receive particular attention. Functions like engagement of casual labour, record of their work, and payment of their wages should be properly segregated.
  - (x) Signatures of the employees to whom the payment is being made should also be obtained. In case the payment is made to someone else, written authority should be obtained.
  - (xi) Surprise checks should be conducted at the time of wage payment by a responsible official independent of the wages and salaries department.
  - (xii) Unclaimed wages and salaries should be immediately recorded in the unpaid wages and salaries register & their subsequent payment should be made only on the specific claim of the employees.
  - (xiii) Deductions on account of Provident funds, Employees State Insurance contributions etc. should be regularly made. A responsible person should satisfy himself whether remittances of such deductions have been properly made to the statutory authorities.
  - (xiv) Recoveries in respect of loans towards house building, P.F. loans etc. should be regularly made.

(xv) Examine reimbursement of certain expenses like conveyance charges, mileage claims etc.

**b. Audit of Commercial Accounts:** The government also engages in commercial activities and for the purpose it may incorporate following types of entities:

- (i) Departmental enterprises engaged in commercial and trading operations, which are governed by the same regulations as other Government departments such as defence factories, mints, etc.
- (ii) Statutory corporations created by specific statutes such as LIC, Air India, etc.
- (iii) Government companies, set up under the Companies Act, 1956.

All aforesaid entities are required to maintain accounts on commercial basis. The audit of departmental entities is done in the same manner as any Government department, where commercial accounts are kept. Audit of statutory corporations depends on the nature of the statute governing the corporation. In respect of government companies, the relevant provisions of Companies Act, 1956 are applicable. As per section 619 of the Companies Act, 1956 the statutory auditor of a Government company shall be appointed or re-appointed by the CAG. Such an auditor must be a chartered accountant. Further, the Companies Act, 1956, provides that the CAG shall have the powers:

- (i) to direct the manner in which the company's accounts shall be audited by the auditor, and to give the auditor instructions in regard to any matter relating to the performance of his functions; and
- (ii) to conduct a supplementary or test audit of the company's accounts by such person, as he may authorise in this behalf, and for the purposes of such audit to require information or additional information to be furnished to any person or persons, so authorised on such matters by such person or persons, and in such form as the CAG may direct.

The statutory auditor shall submit a copy of his audit report to the CAG, who shall have the right to comment upon or supplement the audit report in such manner he may think fit.

Any such comments upon or supplement to the audit report shall be placed before the company, at the same time, and in the same manner, as the audit report. Thus, it is seen that there is a two layer audit of a Government company, by the statutory auditors, being qualified chartered accountants, and by the CAG. The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

3. (a) As an auditor Megaworld Pvt Ltd. following must be taken into account:

Constitution:

- Noting the financial powers of the executives and the managing committee;
- Checking the Rules, Regulations and Bye laws applicable to the Theatre;
- Ascertainment of the objects for which the license have been issued have been complied with or not;

**Minute Books :**

Scrutinize the minutes of the meetings of Managing committee as regards various financial decisions including various decisions and resolutions affecting accounts requirement etc.

**Income Sale of Tickets:**

Since there has been a theft from the ticket collection box auditor must ensure the effectiveness of the internal control with respect to ticket collection. Surprise physical verification of cash collection must be made at the end of any show to ensure that the collections received are recorded in the books. Other points which must be considered are as follows:

- Ensure that entry to the Cinema Hall during the show is through printed tickets only which are serially numbered and bound into books;
- Verify whether the printed tickets have been endorsed by Commercial Tax Authorities;
- Separate series of tickets is used for Advance Bookings & Free Passes are properly authorized;
- Stock of unsold tickets have been kept in the custody of Responsible Official;
- Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows, based on Daily Statements;
- Reconcile the amount of Entertainment Tax collected with the total number of tickets are issued for each class;

**Advertisement Receipts:**

Verify the advertisement charges collected with reference to the Agreements entered into with the Advertisers; Cross verify the Advertisement Income based on Register of Slides & Shots Exhibited kept at the Cinema Hall;

**Refreshment & Restaurant Income:**

Enquire the arrangement for collection of share in the restaurant income, i.e. fixed % sharing or Fixed Amount charged etc. Ensure whether the income is

properly accounted for; Ensure closing stock of food stuffs, cold drinks, etc. have been duly considered and issues and purchases have been properly authorized;

**Rental & Investment income:**

Rental income with Rent receipts and agreements;

Dividend and Interest income, verify the securities in respect of investments held; Verify whether purchase and sale of investment have been properly authorized.

**Expenditure:**

Ascertain the operation of internal control system over various heads of expenditure;

Vouch the expenditure incurred on advertisement, repair and maintenance;

Verify whether proper sanction exists in respect of regular administrative expenditure like salaries, printing, stationery etc.; Verify whether adequate distinction has been made between capital and revenue expenditure; Vouch payments towards film hire, with bills of distributors and underlying agreements;

**Taxation & Statutory Compliance:**

Verify whether proper tax liability has been assessed and Return of Income was filed within due date; All taxes collected have been remitted to proper authorities on timely basis; All statutory obligations have been remitted to proper authorities on timely basis;

**General**

Verify the fixed assets and ensure that adequate depreciation is provided; Examine unadjusted balances out of advances paid to the distributors against film hire contract, to see they are good and recoverable; Verify that all advances in respect of films already run have been duly adjusted; Ensure that income against advance tickets sold have been duly accounted for and that at the end of year are shown under liability; Verify all the Balance sheet items and verify whether appropriate provisions have been made for replacement of current assets; Compute significant Ratios and seek appropriate explanation for significant deviations; Verify whether the form and manner of presentation of Financial Information conforms to Accounting Standards and applicable legal requirements; Obtain appropriate management representations and certificates in respect of various aspects covered during the course of audit.

- (b) **Management Representation:** The management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. There cannot be any restriction on scope of audit in case of statutory audit.

The management representation, according to SA 580 - Written Representations, cannot substitute other audit evidence that the auditor could reasonably expect to be available to the auditor.

The audit evidences available for checking receivables- say, invoices, debt acknowledgement documents, receipts, statement of accounts, confirmations etc., are available evidences which auditor is duty bound to verify.

Just because management had owned responsibility for the correctness of its evaluation of receivables, the auditor cannot shirk his responsibility. This is negligence on his part if he relies on the management representation without assessing the corroborative available evidences.

4. (a) The Indian Partnership Act, 1932 does not prescribe audit of a partnership firm. Nevertheless, for the verification of adjustment in the accounts of partners made in respect of profits and losses, interest and remuneration of partners, their contribution to capital, etc. It is necessary that the auditor should have a knowledge of the provisions in this regard under the Act—especially that of powers and audit of partners and their right to profit and capital under different situations and circumstances. The auditor may, particularly, ensure application of accounting standards prescribed by the Institute. In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards. Alternatively, only disclosure of non-compliance with the accounting standards, would be sufficient without making it a subject matter of qualification.

#### **Advantages**

On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

- (i) Audited accounts provide a convenient and reliable means of settling accounts between the partners and thereby possibility of dispute among them is mitigated.
- (ii) On the retirement/death of a partner, audited accounts constitutes a reliable evidence for computing the amount due to the retiring partner or representative of deceased partner.
- (iii) Audited accounts are generally accepted by the Income tax authorities for computing the assessable income.
- (iv) Audited accounts are relied upon by banks for advancing loan.
- (v) Audited accounts can be helpful in the negotiation for sale or admission of a new partner.
- (vi) It is an effective safeguard against any undue advantage being taken by a working partner as against the non working partners.

(b) On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at stocktaking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management. CARO 2003 requires specific comment by auditor as to the adequacy, reasonableness of the physical verification of inventory. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for. In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year. Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. If the management does not accept to the auditor's view the auditor may appropriately make qualifications in his audit report.

5. (a) **Appointment of Special Auditor:** Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.

Amongst others, one of the circumstances specified is, in case, a company is not being managed in accordance with sound business principles or prudent commercial practices.

Such an audit aims at providing the government with a critical appreciation of the company and its financial position.

The audit may be conducted either by the company's auditor or another Chartered Accountant who may or may not be engaged in a practice, appointed by the Central Government. The auditor appointed has the same power and duties in the matter of special audit as the statutory auditor of a company has, except for the fact that he must report to the Central Government in place of member of the company. .

**Conclusion:** In view of the above provisions of the Companies Act, 1956, the appointment of Mr. M, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Managing Director is not correct.

- (b) Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees.

This provision aims to ensure that the auditor is independent and under no financial obligation to the company.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company.

Sub section(4) of the Section 226 further lays down that a person is not eligible for appointment as auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company. Similarly A firm of auditors acts through its partners hence no partner should be indebted even in his personal capacity to the entity being audited the debt arising from normal course of business of the entity should also be record for indebtedness.

**Conclusion:** Accordingly, the partner Mr Sri is disqualified to be appointed as auditor of the company as he is indebted to the company for an amount exceeding Rs. 1000. This disqualification is attracted even if it exists on any date during the relevant accounting year.

Due to disqualification of Mr. Sri, Sri & Co., is also disqualified to be appointed as an auditor of Aaradhana Company Ltd.

6. (a) Section 619 of the Companies Act, 1956, the auditor of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. The provision applicable to the appointment of auditor of government companies also apply to another category of companies, even though they are not government companies as contained in section 619B of the Act. As per section 619B of the Companies act 1956 the provisions of section 619 apply to a company in which not less than 51% of the paid up share capital is held by one or more of the following or any combination thereof:
- (i) the Central Government and one or more government companies;
  - (ii) any State Government or Governments and one or more government companies;
  - (iii) the Central Government, one or more State Governments and one or more government companies;
  - (iv) the Central Government and one or more corporations owned or controlled by the Central Government;
  - (v) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;
  - (vi) one or more corporations owned or controlled by the Central Government or the State Government;

- (vii) more than one government company; the auditor of such a company shall be appointed by the Central Government on the advice of the Comptroller and Auditor General of India.

Therefore provisions of section 619 will be applicable to AB Ltd. as a Government Company and the State Government hold 51% of the paid-up share capital of AB Ltd. together.

**(b) Formation of opinion on accounts:** The principal aspect to be covered in an audit to form an opinion, an auditor has to look into following matters:

- (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.
- (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
- (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
- (vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
- (viii) Verification of the liabilities stated in the balance sheet.
- (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
- (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.

- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties of auditor are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

**7. (a) Types of Audit Evidence:** There are two types of Audit evidence:

**Internal evidence and external evidence:** Evidence which originates within the organization being audited is internal evidence. Example – sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization; for example, purchase invoice, supplier's challan and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g., an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

**(b) Substantive Procedures:** These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions

- (i) The asset or a liability should exist at a given date.
- (ii) The asset should be owned by the entity and the liability is an obligation of the entity at a given date.
- (iii) There should not be any unrecorded assets, liabilities or transactions.
- (iv) Assets or liabilities should be recorded at appropriate carrying values.
- (v) Transaction or event that took place should pertain to the entity during the relevant period.
- (vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period.
- (vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

**(c) Importance of Working Papers**

Audit working papers constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and the clients record.

These includes retention of permanent record in the nature of a document to show the actual audit work executed , the nature of work, the extent of work and the important points, facts, dates and decisions having bearing on the audit of the accounts audited. The audit working papers are found very useful in the following aspects as they:

- (i) It provides guidance to the audit staff with regard to the manner of checking the schedules.
- (ii) The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.
- (iii) It acts as evidence in the court of law when a charge of negligence is brought against the auditor.
- (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

- (d) **Re-issue of redeemed debentures:-** A company may issue debentures previously redeemed, either by reissuing the debentures or by issuing others in their place unless the Articles or a contract or resolution, recorded at a General Meeting, or terms of issue or some other act of the company expressly or impliedly manifest the intention that, on redemption, the debentures shall be canceled. However, the re-issue of redeemed debentures or the issue of others in their place are treated as a new issue for the purpose of stamp duty and the rights and privileges attaching to the debentures that re-issued shall be the same as if the debentures had never been redeemed. On these considerations, it is necessary for the auditor to verify the re-issue of debentures in the same manner as those issued for the first time.
- (e) **Cut off procedure:** - Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as “cut-off arrangement”. It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and stock are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and stock. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:
- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
  - (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of stock into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking for perfect and correct presentation in the financial statements.