

MOCK TEST PAPER – 2
INTERMEDIATE (IPC) : GROUP – II
PAPER – 6: AUDITING AND ASSURANCE
SUGGESTED ANSWERS/HINTS

- (1) (a) **AS 10 “Accounting For Fixed Assets”:** As per AS 10 “Accounting for Fixed Assets” When a fixed asset is acquired in exchange for another asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given up, adjusted for any balancing payment or receipt of cash or other consideration. For these purposes fair market value may be determined by reference either to the asset given up or to the asset acquired, whichever is more clearly evident.

The delivery van has been acquired in exchange for another assets i.e. receivables. The fair value of delivery van is ₹ 1,75,000 and that of receivable were ₹ 1, 50,000. Here fair market value of the asset given up is more clearly evident. Therefore the delivery van should be valued at ₹ 1, 50,000. Also the delivery van should be recognized as an asset of the company even though it is not yet registered in the name of the company. This is because legal title is not necessary for an asset to exist. What is necessary is control over the asset as per the framework for preparation and presentation of financial statements. Applying substance over form, we find since price has been settled, and the company has control of assets, hence it should be reflected as an asset along with a note to the effect that the registration in the name of the company is pending.

- (b) **Contribution To Charitable Funds:** As per the provisions of Section 293 of the Companies Act, 1956 the Board of Directors of a Public Ltd. Co., with the consent of the Company in general meeting can contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amounts the aggregate of which will, in any financial year, exceed fifty thousand rupees or five per cent of its average net profits as determined in accordance with the provisions of Sections 349 and 350 during the three financial years immediately preceding, whichever is greater.

In the given case company gave two donations of ₹ 50,000 each to a charitable school and a trust for blinds i.e. ₹ 1,00,000, those are not directly relating to business of the company or the welfare of its employees. According to given situation Board of directors can contribute either (i) ₹ 50,000 or (ii) 5% of average net profit of least 3 financial years i.e. ₹ 60,000 whichever is greater.

Therefore Board of Directors can contribute maximum of ₹ 60,000 to both Charitable institutions with the consent of the company in general meeting. The action of Board of directors is not correct. It has violated the provision of Section

293 of the Companies Act, and as an auditor, this matter should be reported in the auditor's report.

- (c) **Disclosure of certain ordinary activities under AS 5 :** As per AS 5 "Net Profit or Loss for the Period, Prior Period Items and changes in Accounting Policies "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

During the relevant year, the company had collected the amount of ₹ 23 lakhs for which provision had already been made earlier in the accounts. The said provision should be reversed to that extent during the relevant year. The company estimates a doubtful debt to the extent of ₹ 25 lakhs in the current year which must be provided for during the relevant year. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 of AS 5 include reversals of provisions. The company had netted off the reversal and additional provision and had shown the net debit of ₹ 2 lakhs in P&L account. This practice does not seem to be good as per AS 5. Company may show the net debit in P&L account but should disclose the facts of write back and additional provision made during the year by way of note. The Company's accounting treatment is wrong and it may warrant audit qualifications.

- (d) **Segmental reporting:** As per AS 17, the company accounts must be presented according to the primary classification based on nature of income and expenses and therefore segment results are to be disclosed accordingly. The result of segment should be disclosed in terms of segment revenue and segment expense.

In the instant case, the company has two business segments namely assembly and transportation. These two segments should be properly identified.

In this case, company should add note to show segment result after computation. It is not necessary that segment-wise details of each and every expenditure and revenue should be specified.

2. (i) Cash in Hand ₹ 10,000

This is the item of current assets, exhibited on the asset side of balance sheet It implies:

- (1) that the firm concerned has ₹ 10,000 in hand in valid notes and coins on the balance sheet date.
- (2) that the cash was free and available for expenditure to the firm.
- (3) that the books of accounts show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

(ii) Investments ₹ 1,00,000

This is also the item to be exhibited on the asset side of balance sheet as per Schedule VI as prescribed by Company Law. This description is not giving us a complete picture of investment. We, as an auditor, must know:

- (1) Nature of Investment, type of Investment; whether it is short term or long term investment or trade investment or non-trade investment.
- (2) Rate of interest receivable.
- (3) Face value or market value of investments as on balance sheet date.

(iii) Secured Loan ₹ 10,00,000

It Implies that the company has secured loan from some parties, worth ₹ 10,00,000. The description does not give us a complete picture. We, as an auditor, must know:

- (1) the name of the lender,
- (2) the nature of security provided; and
- (3) the rate at which interest is payable.

(iv) Machinery ₹ 11,70,000.

- (1) The Company owns the Plant and Machinery whose WDV as on date of balance sheet is ₹ 11,70,000. Gross block is ₹ 13,00,000.
- (2) The Machinery physically exists.
- (3) The asset is being utilized in the business of the company productively.
- (4) Charge of depreciation on this asset is ₹ 1,30,000 relates to the year in respect of which the accounts are drawn up.
- (5) The amount of depreciation, has been calculated on recognized basis and the calculation is correct.

3. (a) Contingent Liability: Accounting Standard (AS) 29 on 'Provisions, Contingent Liabilities and Contingent Assets', defines:

'Contingent Liability':

- (a) is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) is a present obligation that arises from past events but is not recognised because it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a reliable estimate of the amount of the obligation cannot be made.

'Possible Obligation' – an obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

'Present Obligation' – an obligation is a present obligation if based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

Contingent liability should not be recognised but disclosed if the possibility of an outflow of resources embodying economic benefits is not remote and the amount of obligation cannot be measured with sufficient reliability to be recognised as a provision. Contingent liability should be continually reviewed and if it becomes probable that an outflow of future economic benefits will be required, then contingent liability should be recognised as a provision.

As per the revised version of Schedule VI (applicable from 1.4.2011 for financial year 2011-2012 and onwards), the Contingent Liabilities have to be presented in notes to accounts in the following manner:

Contingent liabilities and commitments (to the extent not provided for):

- (i) Contingent liabilities shall be classified as:
 - (a) Claims against the company not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the company is contingently liable
- (ii) Commitments shall be classified as:
 - (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;
 - (b) Uncalled liability on shares and other investments partly paid

Other commitments (specify nature).

- (b) Treatment of Heavy Advertisement Expenditure:** Advertisement expenditure is generally of revenue nature and is thus written off to the profit and loss account in the year it is incurred. However, A Ltd. has incurred "heavy" advertisement expenditure to launch a new product. In such a case, it is the normal expectation that the benefit of such an expenditure is likely to bring benefits over a longer period. Therefore, heavy expenses for a new product, if campaign is successful, are normally treated as deferred revenue expenditure to be written off over a period of three to five years. Thus, deferral of expenditure is done only with the anticipation that benefit is likely to accrue in future accounting periods. It appears from the given facts that the product did not pick up and the sales were negligible. Therefore, it is almost established that the advertising effort is not going to succeed, i.e., no benefit is likely to flow in future. Thus, the entire expenses incurred should be written off to

the Profit and Loss Account. Accordingly, the writing off of the entire expenditure to revenue is appropriate and correct.

- (c) **Car Purchased on Hire-Purchase Basis:** The Managing Director's car was acquired on hire-purchase basis and, thus, the motor car account be debited with the cash price of car by raising a corresponding liability for the amount payable to the financing company. If the cash value is not readily available, it should be calculated by assuming an appropriate rate of interest. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account. In any case, the amount paid as penalty for late payment of installments should be debited as an expense instead of being added to the cost of the car. Under the circumstances, the auditor will have to qualify his report.
4. (a) The term "internal check" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". The following aspects should be considered in framing a system of internal check:
- (1) No single person should have an independent control over any important aspect of the business. The work done by one person should automatically be checked by another person in routine course.
 - (2) The duties/work of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
 - (3) Every member of the staff should be encouraged to go on leave at least once in a year so that frauds successfully concealed by such a person can be detected in his absence.
 - (4) Persons having physical custody of assets must not be permitted to have access to the books of accounts.
 - (5) There should be an accounting control in respect of each important class of assets, in addition, these should be periodically inspected so as to establish their physical condition.
 - (6) The system of Budgetary Control should be introduced.
 - (7) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to other than stock section.
 - (8) The financial and administrative powers should be sub divided very judiciously and the effect of such division should be reviewed periodically.
 - (9) Finally, the system must be capable of being expanded or contracted to

correspond to the size of the concern.

(b) The following precautions may be taken in applying test check techniques:

- (i) Transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of same kind.
- (ii) Study and evaluation of internal control system should be exercised for its efficiency, soundness and capability for producing reliable accounting and financial data.
- (iii) System of authorization, documentation, recording and evidencing of transaction should be examined.
- (iv) A properly thought - out test check plan should be prepared to match with the audit objective and avoid mix-up in the objective.
- (v) Selection of transactions should be made in such manner so that bias cannot enter in the selection.
- (vi) Identification of the area where the check may not be done.
- (vii) The number of transaction to be selected for each test check plan should be predetermined based on degree of reliance that should be placed on test check result and confidence that can be placed.
- (viii) Materiality of the error as a result of test check must be pre-determined and criteria be fixed to judge the same. Only the material errors may be properly and thoroughly investigated.

- 5. (a)** According to the SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure" accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. SA 540 addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.

Additional examples of accounting estimates are:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.

Financial Obligations / Costs arising from litigation settlements and judgments.

- (b) External confirmation:** As per SA 505 “External Confirmations” Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

The auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. Following are examples of situations where external confirmations may be useful.

- (i) Bank balances and other information from bankers
- (ii) Account receivables balances
- (iii) Stock held by third parties
- (iv) Account payable balances.

6. (a) Audit of Charitable Institutions

In the case of the audit of a charitable institution, attention should be paid to the following matters :

(1) General

- (a) Studying the constitution under which the charitable institution has been set up. It may be registered as a society under the Societies Registration Act, 1860 as a company limited by guarantee or as a trust. If the charitable institution is a public trust, the provision of the State Legislation, if any, affecting its accounts and audit should be taken into account.
- (b) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.
- (c) Examining the system of internal check, especially as regards accounting of amounts collected.
- (d) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

(2) Subscriptions and donations

- (i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.
- (ii) Whether official receipts are issued;
 - (a) confirming that adequate control is imposed over unused receipt books;
 - (b) obtaining all receipt books covering the period under review;
 - (c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;
 - (d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
 - (e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and
 - (f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

- (3) Legacies - Verifying the amounts received by reference to correspondence with any figures and other available information.
- (4) Grants
 - (a) Vouching the amount received with the relevant correspondence, receipts and minute books.
 - (b) Obtaining a certificate from a responsible official showing the amount of grants received.
- (5) Investments Income
 - (a) Vouching the amounts received with the dividend and interest counterfoils.
 - (b) Checking the calculations of interest received on securities bearing fixed rates of interest.
 - (c) Checking that the appropriate dividend has been received where any investment has been sold ex. div. or purchased cum. div.
 - (d) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.
- (6) Rents
 - (a) Examining the rent roll and inspecting tenancy agreements, noting in each case :
 - (i) the amounts of the rents, and
 - (ii) the due dates.
 - (b) Vouching the rents on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.
- (7) Special function, etc. - Vouching gross receipts and outgoings in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.
- (8) Income Tax Refunds - Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves :
 - (a) vouching the Income-tax refund with the correspondence with the Income-tax Department; and
 - (b) checking the calculation of the repayment of claims.

(9) Expenditure

- (a) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited therefrom either directly or indirectly.
- (b) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test-basis.
- (c) Verifying the cash and bank balances.
- (d) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

- (b) **Reliance on the Work of Internal Auditor:** The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors ", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.

- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

- 7 (a) **Audit engagement letter** : Audit engagement letter is a communication issued by auditor to the auditee (the client) expressing therein *inter alia*, the fact of acceptance of his audit engagement, the objectives and scope of his audit, the extent of auditor's responsibilities and management responsibility for compilation of accounting, application of accounting principles, standards, fees. As per SA 210, "*Agreeing the Terms of Audit Engagements*", *the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement. But if Law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement.*
- (b) **Reliability of audit evidence**: As per SA 500 "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself,

is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

(c) Advantages of statistical sampling in auditing

- (i) The sample size does not increase in proportion to the increase in the size of population.
- (ii) The sample selection is more objective and is based on mathematical law of probability.
- (iii) This provides a means of estimating the minimum sample size associated with a specified risk and precision level.
- (iv) It also provides a means for deriving a calculated risk and corresponding precision
- (v) It may provide a better description of large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

- (d) Knowledge of client's business - as per SA315, the auditor "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" Auditor can obtain this information from:
- (i) Clients annual report to shareholders
 - (ii) Minutes of shareholders/board of directors
 - (iii) Internal financial management reports of current & previous year
 - (iv) Previous year audit working papers
 - (v) Discussion with client
 - (vi) Clients policy and procedure manual
 - (vii) Publications like trade journals, magazines, news papers and
 - (viii) Visit to client's premises
- (e) 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.