

MOCK TEST PAPER – 1
FINAL COURSE: GROUP – I
PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS
SUGGESTED ANSWERS/HINTS

1. (a) When obtaining our understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operation including:
- (a) The nature of services provided and the significance of such services to the user entity including its effect on the internal control of user entity.
 - (b) The nature and Materiality of the transactions processed on accounts or financial reporting process affected
 - (c) The degree of interaction between the activities of the service organization and those of user entity and
 - (d) The nature of the relationship between the user entity and the service organization including relevant contractual terms for the activities undertaken by the service organization.
- (b) Misstatements may result from
- (a) An inaccuracy in gathering or processing data from the financial statements are prepared.
 - (b) An omission of an amount of disclosure
 - (c) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts and
 - (d) Judgements of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that auditor considers inappropriate.
- (c) The auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates.
- (a) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
 - (b) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized and disclosed, including changes in circumstances that may need revision in estimates.
 - (c) The estimation making process adopted by the management including

- (i) The method and model used in making estimates
 - (ii) Relevant controls
 - (iii) Whether management used an expert?
 - (iv) The assumption underlying the estimates
 - (v) Need for a change from prior period estimate making process
 - (vi) How the management assessed the effect of estimation uncertainty.
- (d) If the management refuses to allow auditor to send a confirmation request, the auditor shall
- (a) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.
 - (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing* and extent of other audit procedures and
 - (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the audit considers management's request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of Governance and also determine its implication for the audit and his opinion.

2. (a) **Restriction on Statutory Auditor**

The Council Guidelines (2008) of ICAI specifies that a member of the Institute of Chartered Accountants in India, in practice, shall be deemed to be guilty of professional misconduct, if he accepts the appointment as a statutory auditor of a company having a turnover of ₹ 50 crores or more in a year and accepts any other assignment in regard to same company on a remuneration which in total exceeds the fee payable for carrying out statutory audit of the same company.

In view of the above, it would be misconduct on the part of Mr. Moon to accept the assignment of Management Consultancy for a fee of ₹ 50 lakhs.

(b) **Misconduct of Chartered Accountant**

The Council of the Institute of Chartered Accountants of India has categorically stated that in case where a member is a director of a company, the firm, in which the said member is a partner, should not express any opinion on its financial statements. Clause 4 of Part I of the Second Schedule to the Chartered Accountants Act, 1949 states that expressing an opinion on financial statement of any business establishment in which the auditor, his firm or a partner of his firm has a substantial interest would constitute misconduct unless he discloses the interest in

his report. In case, where a member of the Institute is a director of a company or a firm in which said member is a partner should not express any opinion on its financial statements.

In this case, firm RJ & Co. has been retained only to evaluate the cost of products manufactured by it for information system, which does not involve expression of opinion on financial statements. Therefore, RJ & Co. can accept the assignment.

(c) Branch Office

In terms of Section 27 of the Chartered Accountant Act, 1949 if a Chartered Accountant in practice has more than one office in India, each one of these offices should be in the separate charge of a member of the Institute. There is however, an exemption for the above, if the second office is located in the same premises, in which the first office is located; or the second office is located within a distance of 50 kms from the municipal limits of the first office's location.

In this case, since the second office is situated within 50 kms, Mr. A would not be considered as having committed professional misconduct.

(d) Prohibition on solicitation of work

Clause 6 of Part I of First Schedule to the Chartered Accountant Act, 1949 prohibits solicitation of work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means, would constitute professional misconduct.

The bio-data of the Member handed over during the interview was read out which contained personal recognition and achievements of the partner as an expert in the field of taxation. Such an act would lead to the promotion of his name and publicity thereof to the firm.

Hence it would tantamount to professional misconduct on the part of the partner under Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949.

3. (a) Physical Verification of Fixed Assets

As per CARO, 2003, an auditor is required to report following particulars relating to Fixed Assets under CARO

- (a) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Fixed Assets. [Paragraph 4(i)(a)]
- (b) Whether these Fixed Assets have been physically verified by the management at reasonable intervals: whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of accounts [paragraph 4(i)(b)]
- (c) If a substantial part of Fixed Assets have been disposed off during the year,

whether it has affected the going concern [Paragraph 4(i)(c)]

What constitutes “reasonable intervals” depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

In the instant case, A Ltd., having fixed assets at 10 different locations, in total valuing ₹ 5000 crores is physically verifying the assets every third year. As per CARO, 2003, verification of fixed assets should be done on reasonable intervals, and reasonable intervals may be, in some cases that all assets are verified at least once in every three years. Hence if the auditor is satisfied with the frequency, it is not necessary for A Ltd. to verify the fixed assets on an annual basis. However, a suitable comment to the effect has to be made by the auditor in his report.

(b) Non-remittance of PF & ESI dues

As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”, Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

In the instant case, B Ltd. manufacturing cycles has 150 employees. It has been observed that it is not registered for Provident Fund and ESI Authorities which is prima facie ground to qualify the report. On the other hand, B Ltd. is also not remitting the dues in time. As per CARO, 2003 issued under section 227(4A) of the Companies Act, 1956, the auditor is required to report whether the company is regular in depositing Provident Fund or Employees’ State Insurance (ESI) dues with the appropriate authority.

The reason put forward by the Management that in the absence of registration it can’t be construed that the company is at default of remittance of statutory dues on regular basis is no excuse for not remitting dues in time. Thus, the auditor has to qualify the report.

4. (a) Buy-back of shares

The provisions regulating buy back of shares are contained in Section 77A, 77AA and 77B of the Companies Act, 1956.

The auditor should ensure the compliance of all the provisions relating to buy-back and also see that proper accounting entries have been passed. Audit procedure to be followed may be as under:

- (i) Ensure that the buy-back has been done only out of the company's free reserves or its securities premium account or out of the proceeds of any shares or other specified securities other than out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.
- (ii) Check authorisation in the Articles of Association which is a pre-requisite of any buyback.
- (iii) Examine special resolution passed in the general meeting authorising buyback.
- (iv) Ascertain that quantum of buy-back is either equal to or less than 25% of the total paid up share capital and free reserves but in the case of buy-back of equity shares in any financial year it should not exceed 25% of its total paid-up equity capital in that financial year.
- (v) Check that the debt equity ratio should not be more than 2 : 1 except in cases where Central Government allows higher ratio for a class or classes of companies.
- (vi) Ensure that shares or other specified securities to be bought back should be fully paid-up.

In the instant case, the action of the company is not valid. The company at the most is eligible to buyback 25% of paid up capital and free reserves i.e. 25% on ₹ 45,00,000 which would amount to ₹ 11,25,000 only. Hence, passing of Special Resolution at the Annual General Meeting for buy back of shares to the extent of ₹12, 50,000 is invalid.

- (b) As per the Schedule VI of the Companies' Act, 1956, sundry debtors and loans and advances should be classified into:

A. Sundry Debtors:

1. Classification by Age

- (a) Debtors outstanding for a period exceeding 6 months and
- (b) other debts.

The amount of provision for doubtful debts shall be shown separately. This is called classification by Age.

2. **Classification by nature:**

- (a) Debts considered good and in respect of which the company is fully secured.
- (b) Debts considered good for which the company holds no security other than the debtor's personal security and
- (c) Debts considered doubtful or bad.

3. **Classification by party:**

- (a) Debts due by the Directors or other officers of the company, or any of them severally or jointly with any other person. (The term "officer" includes any Director, Manager, or secretary but not auditor).
- (b) Debts due by Firms or private companies respectively in which any director is a partner or a director or a member, as the case may be.
- (c) Debts due from other companies under the same management alongwith names of companies concerned.

The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note.

4. **Provisions:** Provisions shown herein should not ensure the amount of the debts considered doubtful or bad-surplus provided, if any shall be shown as a revenue under the head "reserves and surplus" under the heading "Reserve for Doubtful or bad debts".

5 **Excluded items:** The amounts to be shown under sundry debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations, but shall not include the amounts which are in the nature of loans or advances.

B. Loans & Advances

- 1. (a) Advances and loans to subsidiaries
- (b) Advances and loans to partnership firms in which a company or any of its subsidiaries is a partner
- 2. Bills of exchange
- 3. Advances recoverable in cash or kind or for value to be received
- 4. Balances with customs, Port Trust etc.

Conclusion:

In the instant case, PQR Pvt. Ltd has not classified Sundry Debtors and Loans & Advances as per Schedule VI of the Companies Act.

5. (a) (i) **Using the work of an Expert** : As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans, however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

Hence, the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

If the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be ensured by the auditor.

In the instant case, a qualified actuary has issued a certificate for gratuity liability valuation, for which retirement age adopted is 65 years against the existing retirement age of 60 years; however, the company is considering a proposal to increase the retirement age. In view of SA 500 alongwith SA 620, the assumption made by actuary has no relevance and reasonableness as presently retiring age is of 60 years. Hence the auditor is required to bring out the facts to the notice of management and advice the modification accordingly. In case of failure of compliance of the same the auditor may qualify the report.

- (ii) **Payment of dividend:** Profit arising due to crediting a time-barred liability of this nature is a capital profit. It will be available for distribution as dividend only if the following three conditions are fulfilled.

As per Guidance Note on 'Audit of Payment of Dividend', capital profits can be distributed as dividend only if all the following conditions are fulfilled:

- (i) the Articles or the bye-laws or other rules and regulations applicable to the entity, permit such distribution; and
- (ii) it has been realised in cash; and
- (iii) the Board or similar authority is satisfied that net aggregate value of the assets remaining after distribution of that profit will not be less than the book values so that share capital and reserves remaining after the distribution will be fully represented by the remaining assets.

Moreover, section 205 of the Companies Act, 1956 does not make any distinction between capital profit and other profit. Thus, all profits which can properly be taken to the profit and loss account are 'profits' for the purposes of section 205 and are, thus, distributable.

In the instant case, the company has converted the loss into profits by crediting the time bound liability relating to purchase of fixed assets. Profit arising due to crediting a time-barred liability of this nature is a capital profit which is not realised in cash. Hence, declaration of the dividend out of such profits is not valid. The auditor should qualify the report.

- (b) **On-line real time systems:** The on-line real time system enables the users to access data and programmes directly through terminal devices. When an organisation uses an on-line system, the technology is likely to be complex and it is linked with strategic business plan. The individual transactions are entered at terminal devices, validated and used to update related computer files immediately. Transactions are entered as they occur, and are processed on entered. This system forms the heart of management information system. An example is the application of cash receipts directly to customers' accounts. The results of such processing are then available immediately for inquiries or reports.

However, if the user wants to process the data after validation then the on-line/batch processing system may be used.

Batch processing system: In on-line batch processing system, individual transactions are entered at a terminal device subject to certain validation checks and added to a transaction file that contains other transactions entered during the period. The transaction file may be validated further during every processing cycle and relevant master file is updated. Transactions are accumulated and grouped for the day and processed as a group. They do not process transaction as quickly as more advanced online system does.

The auditor may offer his suggestion on both cases after taking the requirement of the organization into consideration and based on cost benefit analysis.

6. (a) (i) **Income Recognition:** Reserve Bank of India has issued guidelines to be followed by all scheduled commercial banks – for income recognition, asset classification, provisioning and other related matters. In case of Non Performing Assets (NPA) accounts, income should be recognised only on realisation irrespective of the system of accounting followed. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted. Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

In the instant case, where two of the ten parties have paid part interest only whereas bank has accounted full amount of interest accrued as income in respect of two parties. Hence, the auditor should indicate the same in his report.

(ii) **Drafts paid without advice:** This balance is in the nature of a suspense account in as much as it represents payments made on account of drafts issued by other branches but for which the relevant advice from those branches have not been received. It is, therefore, most important to examine the system of internal control operating in the bank in this respect. The testing of the internal control system has to be made mainly with regard to the following:

- (i) the system of verifying the authenticity of the draft by reference to specimen signature of the signing authority and the *prima facie* correctness and completeness of the draft in all respects;
- (ii) the system of co-relating drafts paid with advices subsequently received; and
- (iii) the system of sending reminders where advices are not received within a reasonable time and the recording of reasons for their non receipt.

The composition of the balances appearing in this account has to be verified with particular reference to any long outstanding items. The auditor should further verify whether the items appearing in this account have been subsequently cleared on receipt of the relevant advices. It would also be useful to have on record the names and addresses of the payees of such drafts.

The auditor may seek confirmation of transactions relating to such outstanding cases. The auditor should also pay special attention to unusual items in suspense account. He should obtain details for the delay in adjusting the entries and if it requires provisions or write-off he has to ensure that the same has been made.

(b) Engagements to Compile Financial Information for Tax Audit Purpose: As per SRS 4410 "Engagements to Compile Financial Information", if the accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading, the accountant should withdraw from the engagement.

As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the tax auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. The tax auditor should also examine the basis adopted for ascertaining the cost and ensure that this basis is consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In the instant case, AB & Co, Chartered Accountants was appointed to compile financial statements for tax audit purpose of Y & Co, a firm. It is the duty of AB & Co, to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In this case, the stock valuation was grossly understated. Consequently, the disclosure of profit is also not correct. Hence the contention of the management of Y & Co, that AB & Co are not the statutory auditors, so they need not be concerned about valuation of stock is not correct. Hence, the auditor may withdraw from the engagement if the management insists on their stand.

7. (a) **Other Misconduct:** A member is liable to disciplinary action if he is found guilty of any professional or 'other misconduct'. Other misconduct has not been defined under the Act. This provision empowers the council to enquire into any misconduct of a member even if does not arise out of profession. This is considered necessary because Chartered Accountant is expected to maintain highest standards of integrity in personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative would be liable to disciplinary action even though the forgery may not have been done in the course of his professional duty.

A particular act or omission, whether it constitutes 'misconduct' or not has to be decided on facts of each case. It would also relate to conviction for an offence involving not of a technical nature committed by the member in his professional capacity.

Some illustrative examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are:

- (i) Where a chartered accountant retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
- (ii) Where a chartered accountant makes a material misrepresentation.
- (iii) Where a chartered accountant uses the services of his articled or audit clerk for purposes other than professional practice.
- (iv) Conviction by a competent court of law for any offence under Section 8 (v) of the Chartered Accountants Act 1949.
- (v) Misappropriation by office-bearer of a Regional Council of the Institute, of a large amount and utilisation thereof for his personal use.
- (vi) Non-replying within a reasonable time and without a good cause to the letter of the public authorities.

(b) Rolling Statement:

A rolling settlement is one in which trades outstanding at the end of the day have to be settled (payments made for purchases or deliveries in the case of sale of securities) within "X" business days from the transaction date. If a transaction is entered on Monday on T + 2 Rolling Statement, it will be settled on Wednesday when pay in or payout take place.

In the rolling settlement, trades on each single day are settled separately from the trades done earlier or subsequent trade days. The netting of trades is done only for the day and not for multiple days.

SEBI has mandated most of the scrips to be settled exclusively on rolling settlement basis. If a member fails to deliver the shares sold in rolling settlement, the exchange conducts an auction session to meet the shortfall credited by non-delivery of shares.

(c) Corporate Governance:

A system, by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely reporting. Clause 49 deals with composition of Board, contents of management discussions and analysis report etc. It is also specified that annual report should contain a separate section on corporate governance. Non-compliance of any mandatory requirement has to be highlighted statutory auditor should also give a certificate to the effect that conditions of corporate governance has been complied with.

(d) Inquiry: "SA 500 Audit Evidence" mentions inquiry as one of the methods of collecting evidence by seeking appropriate information from knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiries may range from formal written inquires addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information, which he did not possess earlier or may not provide him with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

The need for inquiry may arise at every stage of auditing. Evaluating responses to inquiries is an integral part of the inquiry process.

Auditor has to make a statement in his report whether he has obtained all information and explanation that he considered necessary for audit. This is possible through inquiry, as one of the methods of obtaining information.

- (e) **Reconciliation of Cost and Financial Records:** The cost records should be reconciled (preferably periodically with the financial books of account so as to ensure accuracy.) Variations, if any, should be clearly indicated and explained. The period for which such reconciliation be effected should not exceed the period of the financial year of the company.

The reconciliation should be done in such a manner that profitability of the product under reference can be correctly adjudged and reconciled with the overall profits of the company. A statement showing the total expenses incurred by the company, including expenses excluded from the costing records and expenses on products not covered by the relevant Cost Accounting Records Rules, should be prepared and the share of the product covered by the Rules in such expenses should be indicated. Also the sale realisation of the products should be shown separately for products covered by the Rules and products not so covered and the margin representing the difference between respective sales realisation and the corresponding total cost should be determined. This statement in turn should be reconciled with the financial profit and loss account for the period. It may be mentioned that where a system of integrated cost and financial accounting is in operation, this reconciliation will be facilitated to a large extent. In this connection it may be noted that Schedule VI to the Companies Act requires the companies to give considerable amount of information regarding licensed capacity, installed capacity, actual production, consumption of raw material, etc. It should be ensured that the specific information required to be contained in both the costing and financial statements is not different. If at all any difference arises, the same should be properly reconciled and kept on record for reference.

A cost auditor is required to express an opinion as to whether the company has maintained cost accounting records so as to give a true and fair view of cost of production. For this purpose, he has to ascertain cost of raw material consumed; power and fuel; labour cost; royalty and licence payment and etc. Annexure to cost audit report require information on capital employed; net worth and etc. It is therefore, necessary for cost auditor to refer the financial records and to have reconciliation with financial accounts as a part of cost audit report.