

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/HINTS

1. (a) As per SA 402 "Audit Considerations relating to an Entity Using a Service Organisation", for obtaining understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", 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:
 - (i) The nature of services provided by the service organisation and the significance of such services to the user entity, including its effect on the internal control of user entity.
 - (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.
 - (iii) The degree of interaction between the activities of the service organization and those of user entity and
 - (iv) The nature of the relationship between the user entity and the service organization including the relevant contractual terms for the activities undertaken by the service organisation.
- (b) As per SA 450 "Evaluation of Misstatements Identified during the Audit", misstatements may result from
 - (i) An inaccuracy in gathering or processing data from which the financial statements are prepared.
 - (ii) An omission of an amount of disclosure.
 - (iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts and
 - (iv) Judgements of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.
- (c) As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", 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.
 - (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

- (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
- (iii) The estimation making process adopted by the management including
 - (1) The method, including where applicable the model, used in making the accounting estimates
 - (2) Relevant controls
 - (3) Whether management has used an expert?
 - (4) The assumption underlying the accounting estimates
 - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.
- (d) SA 505 "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to send a confirmation request, the auditor shall
 - (i) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.
 - (ii) 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
 - (iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation 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) **Advising on Portfolio Management Services:** The Council of the Institute of Chartered Accountants of India (ICAI) pursuant to Section 2(2)(iv) of the Chartered Accountants Act, 1949 has passed a resolution permitting "Management Consultancy and other Services" by a Chartered Accountant in practice. A clause of the aforesaid resolution allows Chartered Accountants in practice to act as advisor or consultant to an issue of securities including such matters as drafting of

prospectus, filing of documents with SEBI, preparation of publicity budgets, advice regarding selection of brokers, etc. It is, however, specifically stated that Chartered Accountants in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a chartered accountant in practice is not permitted to manage portfolios of his clients.

In view of this, P would be guilty of misconduct under the Chartered Accountants Act, 1949.

- (b) **Advertisement of Professional Attainments:** Clause 7 of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits advertising of professional attainments or services of a member. It also restrains a member from using any designation or expression other than that of a Chartered Accountant in documents through which the professional attainments of the member would come to the notice of the public. Even a member is not permitted to specify the date of setting up of practice or establishment of firm. However, there is no prohibition for printing names of all the three firms on the personal letterheads in which a member holding Certificate of Practice is a partner. Thus B is not guilty of any misconduct under the Chartered Accountants Act, 1949.
- (c) **Developing Website:** As per the guidelines laid down under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 in respect of websites by chartered accountants in practice, it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s XYZ Associates provided a link to "All India Chartered Accountants Association" which is not permitted. Hence the firm would be liable for misconduct under Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949.
- (d) **Responding to Tenders:** Clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949 lays down guidelines for responding to tenders, etc. As per the guidelines if a matter relates to any services other than audit, members can respond to any tender. Further, in respect of a non-exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposits.

In the instance case, since computerization of land revenue records does not fall within exclusive areas for chartered accountants, M/s LMN can respond to tender as well as deposit ₹ 50,000 as earnest deposit and shall not have committed any professional misconduct.

- 3. (a) Internal control system include separation of duties, delegation of authority and responsibility, a system of authorisation, adequate documents and records, physical control over assets and records, management supervision, independent checks on performance and periodic reconciliation of assets with records. In CIS environment, all these components must exist but computers affects the implementation of these internal controls in many ways. Some of the effects are as under:

- (1) **Separation of Duties** - In a manual system, different persons are responsible for carrying out function like initiating, recording of transaction, safeguarding of assets, does not always apply in a computer system. For example, in a computer system, a program may carryout reconciliation of vendor invoice against a receipt document and also prepares a cheque payable to creditors. Such operation through a program will be considered as incompatible functions in a manual system.

In minicomputer and microcomputer environments, separation of incompatible function could be even more difficult. Some such forms, allows, users to change programs and data entry without providing a record of these changes. Thus, it becomes difficult to determine whether incompatible function have been performed by system users.

- (2) **Delegation of Authority And Responsibility** - A structured authority and responsibility is an essential control within manual and computer environment. In a computer system however, a clean line of authority and responsibility might be difficult to establish because some resources are shared among multiple users. For instance, one objective of using a data base management system is to provide multiple users with access to the same data, thereby reducing the control problems that arise with maintaining redundant data, when multiple users have access to the same data and the integrity of the data is somehow violated, it is not always easy to trace who is responsible for corrupting the data and who is responsible for identifying and correcting the error. Some organisation identified a single user as the owner of the data.
- (3) **Competent and Trustworthy Personnel** - Skilled, competent, well-trained and experienced in formation system personnel have been in short supply. Since substantial power is often vested in the person responsible for the computer information system development, implementation, operation and maintenance within the organisation, competent and trustworthy personnel is very much in demand. Unfortunately, the non availability of competent personnel, forced many organisation to compromise on their choice of staff. Moreover, it is not always easy for organisation to assess the competence and integrity of their system staff. High turnover among those staff has been the norm. Some information systems personnel lack a well developed sense of ethics and some enjoy in subverting controls.
- (4) **System of Authorisation** - Management authorisation of transaction may be either:
- (i) general authorisation to establish policies for the organisation,
 - (ii) specific authorisation applying to individual transactions. In manual system, auditors evaluate the adequacy of procedures for authorisation by examining the work of employees. In a computer system, authorisation

procedures often are embedded within a computer program. In a computer system, it is also more difficult to assess whether the authority assigned to individual persons is constant with managements policies. Thus, in evaluating the adequacy of authorisation procedures, auditors have to examine not only the work of employees but also the veracity of the programme processing.

- (5) **Adequate Documents and Records** - In a manual system, adequate documents and records are required to provide an audit trail of activities within the system. In computer system, document support might not be necessary to initiate, execute and records some transaction. The task of a visible audit trail is not a problem for auditors, provided the systems have been designed to maintain a record of all events and that they are easily accessible. In well-designed computer systems, audit trails are more extensive than those maintained in manual systems unfortunately not all computer systems are well designed. This creates a serious control problem.
- (6) **Physical Control over Assets And Records** - Physical access to assets and records is critical in both manual systems and computer system. In a computer system the information system assets and records may be concentrated at a single site. The concentration of information systems assets and record also increases the losses that can arise from computer abuse or disaster. If the organisation does not have another suitable backup, it might be unable to continue operations.
- (7) **Adequate Management Supervision** - In a computer system, supervision of employee might have to be carried out remotely. Supervisory controls must be built into the computer system to compensate for the controls that usually can be exercised through observation and in inquiring computer system also make the activities of employees less visible to management. Because many activities are electronically controlled managers must periodically access the audit trial of employee activities and examine it for unauthorised actions.
- (8) **Independent Checks On Performance** - Checks by an independent person help to detect any errors or irregularities. In a computer system, if a program code is authorised accurate, and complete the system will always follow the laid down procedures in absence of other type of failures like hardware or systems software failure. Thus, independent checks on the performance of programs often have little value. Instead, the control emphasis shifts to ensuring the veracity of programme code. Auditors, must now evaluate the controls established for program development, modification operation and maintenance.
- (9) **Comparing Recorded Accountability with Assets** - In a manual system, independent staff prepares the basic data used for comparison purposes. In a

computer system software is used to prepare this data. If unauthorised modifications occur to the program or the data files that the program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

(b) Basic Accounting Control Objectives

The basic accounting control objectives which are sought to be achieved by any accounting control system are:

- (i) Whether all transactions are recorded;
- (ii) Whether recorded transactions are real;
- (iii) Whether all recorded transactions are properly valued;
- (iv) Whether all transactions are recorded timely;
- (v) Whether all transactions are properly posted;
- (vi) Whether all transactions are properly classified and disclosed;
- (vii) Whether all transactions are properly summarized.

(c) Audit risk at financial statement level

The following factors will be considered for determination of audit risk at financial statement level.

- (i) Integrity of Management.
- (ii) Management experience, knowledge and changes during the period.
- (iii) Unusual pressures on the Management.
- (iv) Nature of entity's business.
- (v) Factors affecting the Industry in which the entity operates.

4. (a) (i) Under clause 27, following particulars as to tax deduction has to be furnished in Form 3CD as under:

- (a) Whether the assessee has complied with the provisions of Chapter XVII-B regarding deduction of tax at source and regarding the payment thereof to the credit of the Central Government [Yes/No]
- (b) If the provisions of Chapter XVII-B have not been complied with please give the following details*, namely:

		Amount
(i)	Tax deductible and not deducted at all	
(ii)	Shortfall on account of lesser deduction than required to be deducted	
(iii)	Tax deducted late	

(iv)	tax deducted but not paid to the credit of the Central Government	
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In case test checking has been done for the above (in case of voluminous data) an appropriate disclosure for the same is to be given.

- (ii) Reporting for expenditure incurred at clubs is to be given as per clause 17(d) of Form 3CD. The payments may be for entrance fees as well as membership subscription and for catering and other services by the club, both in respect of directors and other employees in case of companies and for partners or proprietors in other cases. The fact whether such expenses are incurred in the course of business or whether they are of personal nature should be ascertained. If they are personal in nature, they are to be shown separately under Clause 17(b)

(b) The following areas need to be verified in this regard:

- (i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.
 - (ii) Showing a larger cash discount than actually allowed.
 - (iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.
 - (iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.
 - (v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.
 - (vi) Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.
 - (vii) Under-casting the receipts side of the Cash Book or over-casting the payment side; carrying over a shorter total of the receipts from one page of the Cash Book to the next or over-carrying the total of the payment from one page of the Cash Book to the next with a view to covering up misappropriation; either short banking of cash collection or apart of the amount withdrawal from the bank.
- (c) According to the Institute of Cost and Management Accountants of England, cost audit represents the verification of cost accounts and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:
- (i) verification of the cost accounting records such as the accuracy of the cost accounts, cost reports, cost statements, cost data and costing techniques and
 - (ii) examination of these records to ensure that they adhere to the cost accounting principles, plans, procedures and objectives.

The undernoted circumstances may warrant the introduction of cost audit:

- (a) **Price fixation** - The need for fixation of retention prices in the case of materials of national importance, like steel, cement etc. may be useful in knowing the true cost of production.
- (b) **Cost variation within the industry** - Where the cost of production varies significantly from unit to unit in the same industry, cost audit may be necessary to find the reasons for such differences.
- (c) **Inefficient management** - Where a factory is run inefficiently and uneconomically, institution of cost audit may be necessary. It may be particularly useful for the Government before it takes over any unit.
- (d) **Tax-assessment** - Where a duty or tax is levied on products based on cost of production, the levying authorities may ask for cost audit to determine the correct cost of production.
- (e) **Trade disputes** - Cost audit may be useful in settling trade disputes about claim for higher wages, bonus, etc.

5. (i) **Disposal of Fixed Assets:** Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to whether disposal off of 1/3rd of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.

- (ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D lack, ₹ 12 lakhs was not utilised for the purpose of acquiring the R & D equipment.

6. (a) (i) **Overdue interest:** Overdue interest should be excluded from interest outstanding and accrued due while calculating profit. Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue. In practice an overdue interest reserve is created and the credit of overdue interest credited to interest account is reduced.
- (ii) **Compliance with provisions of the Act and Rules:** An auditor of a co-operative society is required to point out the infringement with the provisions of the relevant Co-operative Act Rules and bye-laws. The auditor of a co-operative society is also required to point out various irregularities, improprieties, and departure from the provision of the Act, rules framed thereunder and the bye-laws of the society. The financial implications of such infringements should be properly assessed and quantified by the auditor and they should be reported. Some of the State laws contain restrictions on the payment of dividends, which should be noted by the auditor and if dividend is declared in excess of the prescribed percentage, the fact should be reported by the auditor. Auditor should also ensure that various provisions in the Co-operative Societies Act, such as, restriction on borrowings, investment of funds, contribution to education funds, restriction on loans, etc are also complied with.
- (iii) **Special Report to the Registrar** The auditors are required to report on number of matters as prescribed in various states. In addition to the main report, the auditors are also required to submit by way of schedules/audit memorandum information on the working of the company as well. During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance a special report may become necessary:
- (i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
 - (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
 - (iii) Specific examples of mis-management. Decisions of management against co-operative principles.

- (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

(b) **General Insurance Company – Verification of Agents' Balances:** The following are the audit procedures for verification of outstanding agents' balances:

- (i) Scrutiny and review of control accounts debit balances and their nature should be enquired into.
- (ii) Examination of inoperative balances and treatment given for old balances be looked into.
- (iii) Enquiring into the reasons for retaining the old balance.
- (iv) Verification of old debit balances which may require provision or adjustment. Explanation be obtained from the management in this regard.

7. (a) Mark to Market Margin (MTM)

MTM margin is the notional loss, which a stock member or his client would incur, if the net cumulative outstanding positions in all securities were closed out at the closing price of the relevant trading day, which is different from the price at which the transaction had been entered into. For each security, this is worked out by multiplying the difference between the closing price and the price at which the trade was executed by the cumulative buy and sell open position (for buy position the close price being lower than actual trade price and for sell position the close price being higher than actual trade price). The aggregate amount computed across all securities is MTM margin payable by a member. The mark-to-market margin is payable with reference to net position at client's level.

(b) **Basic Elements of Auditor's Report:** As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements:

- (a) A title;
- (b) An addressee, as required by the circumstances of the engagement;
- (c) An introductory paragraph that identifies the financial statements audited;
- (d) A description of the responsibility of management (or other appropriate term) for the preparation of the financial statements;
- (e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:
 - A reference to Standards on Auditing and the law or regulation; and

- A description of an audit in accordance with those Standards;
- (f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework);
- (g) The auditor's signature;
- (h) The date of the auditor's report; and
- (i) The place of signature.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards issued by the Institute of Chartered Accountants of India and International Standards on Auditing.

- (c) **Sampling Risk:** As per SA 530 "Audit Sampling", the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
 - (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- (d) **Walk through Tests:** A walk through is a procedure in which an auditor traces a transaction from its initiation through the company's information systems to the point when it is reflected in the financial reports. The auditor should perform one walk through, at a minimum, for each major class of transactions. A walk-through provides evidence to confirm that the auditor understands (1) the process flow of transactions, (2) the design of identified controls for internal control components, including those related to preventing and detecting fraud, and (3) whether all points in the process have been identified at which misstatements related to relevant financial statement assertion could occur. Walk through also provide evidence to evaluate the effectiveness of the controls' design and confirm that the controls have been placed in operation.

When performing a walk-through, the auditor should:

1. Be sure that the walk-through encompasses the complete process (initiation, authorization, recording, processing and reporting) for each significant process identified, including controls intended to address fraud risk.
2. Ask the entity's personnel, at each of key stage in the process, about their understanding of what the company's prescribed procedures require.
3. Determine whether processing procedures are performed as expected on a timely basis, and look for any exceptions to prescribed procedures and controls.
4. Evaluate the quality of evidence provided and perform procedures that produce a level of evidence consistent with the auditor's objectives. The auditor should follow the whole process, using the same documents and technology that company staff use, asking questions of different personnel at each significant stage and asking follow-up questions to identify any abuse of controls or fraud indicators.

Once a walk-through is performed, the auditor may carry forward the documentation, noting updates, unless significant changes make preparation of new documentation more efficient. If such significant changes occur in the process flow of transactions or supporting computer applications, the auditor should evaluate the nature of changes and the effect on related accounts. The auditor should determine whether it is necessary to walk through transactions that were processed both before and after the change.

- (e) **Cut-off Procedures:** Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory. Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

- (a) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.
- (b) Goods sold have been excluded from the inventories and credit has been taken for sales.

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