Mock Test Paper - Series I: March, 2024

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INTERMEDIATE: GROUP – II

PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Division A-Multiple Choice Questions

Case Scenario 1

Question No.	Answer
1.1	**(b)** To verify deferred tax asset likely created in financial statements in accordance with AS 22
1.2	**(b)** The company's accounting treatment of treating cost of CDs with software costs as intangible assets is proper.
1.3	**(b)** The management has properly dealt with such discrepancies. However, Dhanush should bring it to light of engagement partner as it entails specific reporting requirement for auditor under Companies Act, 2013.
1.4	**(d)** Revenue from operations of ₹ 50 crores should be shown in Statement of Profit and loss. However, revenue from sale of books and fees charged from students should be disclosed separately in notes.
1.5	**(c)** prescribed under Schedule II to Companies Act, 2013. However, a company can choose useful life different from what is prescribed under Schedule II.

Case Scenario 2

Question No.	Answer
2.1	**(a)** The accounts of a branch shall be audited either by the company's auditor or by any other person qualified for appointment as an auditor of the company and appointed as such under section 139 of Companies Act, 2013. In case branch accounts are audited by a person other than company's auditor, branch audit report is sent by branch auditor to company's auditor.
2.2	**(c)** Separate determination of materiality and identifying & assessing risk of material misstatement is required along with documentation thereof in respect of each of branches. He is required to perform substantive procedures as described in case study in respect of auditee branches and also maintain documentation of same.

2.3	**(a)**	During year 2023-24, inventories of Branch I have moved faster in comparison to Branch II.
2.4	**(a)**	Company's auditor can advise Mr. D regarding certain significant accounting, auditing and reporting requirements and ask him to provide representation as to compliance with them.

Case Scenario 3

Question No.	Answer	
3.1	**(d)**	Letters of credit issued; guarantees issued (fully secured by 100% margin)
3.2	**(b)**	SA 330
3.3	**(d)**	It would help auditor in identifying accounts which may involve downgrading from standard category to non-performing asset.

General MCQ's

1. (c)

2. (c)

3. (b)

Division B -Descriptive Answers

1. (a) DOX Limited is in business of providing courier services. As name of the company and given facts suggest: -

- It is not a small company under section 2(85) of Companies Act, 2013.
- It is not a private company.
- It is not a one person company.
- It is not a banking or insurance company.
- It is not a Section 8 company as it does not has charitable objects etc.

Therefore, it does not qualify for any exemption from applicability of CARO, 2020. Hence, reporting requirements under CARO, 2020 are applicable. While reporting under CARO, 2020, statutory auditor is required to report under clause (xiv) of paragraph 3 as under:

(a) whether the company has an internal audit system commensurate with the size and nature of its business

(b) whether the reports of the internal auditors for the period under audit were considered by the statutory auditor

(b) The above situation is an example of misstatement relating to non-compliance with requirements of AS 9 identified during audit. In accordance with requirements of SA 450, the auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

(c) In the given situation, following information is required to be disclosed in accordance with requirements to Schedule III to the Companies Act, 2013:

(a)	amount required to be spent by the company during the year ₹14.00 lacs	
(b)	amount of expenditure incurred	₹ 14.50 lacs
(c)	shortfall at the end of the year	NIL
(d)	total of previous years shortfall	NA
(e)	reason for shortfall	NA
(f)	nature of CSR activities - Women empowerment activities through implementing agency	
(g)	details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard	NIL
(h)	where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately	NIL

(d) The firm is providing free hospitality to engagement team members including engagement partner. In such circumstances, fundamental principles governing professional ethics are violated. Such acts of free hospitality are capable of impairing objectivity of auditor.

The situation given in the question signifies that auditors have formed relationships with client where they may end up being too sympathetic to the client's interests. Due to free hospitality enjoyed by engagement team members, they may take a sympathetic view to issues which may have arisen during course of audit. In this way, familiarity threats are created in the situation.

2. (a) **Financial events or conditions that may cast significant doubt on the entity's ability to continue as going concern:**

(i) Net liability or net current liability position.

(ii) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short term borrowings to finance long term assets.

(iii) Indications of withdrawal of financial support by trade payables.

(iv) Negative operating cash flows indicated by historical or prospective financial statements.

(v) Adverse key financial ratios.

(vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.

(vii) Arrears or discontinuance of dividends.

(viii) Inability to pay trade payables on due dates.

(ix) Inability to comply with terms of loan agreements.

(x) Change from credit to cash-on-delivery transactions with suppliers.

(xi) Inability to obtain financing for essential new product development or other essential investments.

(b) **Adequate planning benefits the audit of financial statements in several ways, including the following:**

(a) Helping the auditor to devote appropriate attention to important areas of the audit.

(b) Helping the auditor identify and resolve potential problems on a timely basis.

(c) Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

(d) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

(e) Facilitating the direction and supervision of engagement team members and the review of their work.

(f) Assisting, where applicable, in coordination of work done by auditors of components and experts.

(c) Example of practical limitation on ability of auditor to obtain audit evidence

An auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Example of legal limitation on ability of auditor to obtain audit evidence

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

(d) The above company is a government company. Section 143(5) of the Companies Act,2013 states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) of section 139 i.e. appointment of subsequent auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statements of the company.

3. (a) Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. Purchase bill of ₹ 5.00 lacs pertaining to TIM Industries has been entered in books of TIM Private Limited. Therefore, it is contradicting management's assertion relating to occurrence of such purchases. Hence, it constitutes audit evidence.

Further, the absence of information (for example, management's refusal to provide a requested representation) is used by auditor, and therefore, also constitutes audit evidence. In the given case, management has refused to provide a written representation relating to physical verification of inventories during the year. Therefore, absence of information is used by auditor and it also constitutes audit evidence.

(b) As described in the situation given in the question, banking regulator has imposed restrictions due to non-compliance with regulatory requirements and there is material uncertainty of such events or conditions which may cast a significant doubt on ability of Bank to continue as going concern. However, the financial statements of Bank do not make adequate disclosure of material uncertainty due to above events in financial statements.

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

(i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

(c) SA 300 states that auditor shall develop an audit plan that shall include description of-

(i) The nature, timing and extent of planned risk assessment procedures

(ii) The nature, timing and extent of planned further audit procedures at assertion level

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

(d) Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The objective of the auditor in accordance with SA 230 is to prepare documentation that provides: -

(i) A sufficient and appropriate record of the basis for the auditor's report and

(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

4. (a) Following audit procedures can be performed to perform to verify that recorded sales in financial statements represent goods actually sold during the period and recorded sales are not overstated.

➢ Check whether a single sales invoice is recorded twice or a cancelled sales invoice has been recorded.

➢ Test check few invoices with their relevant entries in sales journal.

➢ Obtain confirmation from few customers to ensure genuineness of sales transaction

➢ Check whether any fictitious customers and sales have been recorded.

➢ Verify whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure

➢ Whether unearned revenue recorded as earned.

➢ Whether any substantial uncertainty exists about collectability

- Whether customer obligations are contingent on other (financing, resale, etc.).
- Review sequence of sales invoices
- Review journal entries for unusual transactions
- Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for unusual variation.

(b) The list given in the question does not contain following important matters: -

- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting. The auditor has to evaluate management's instructions for recording and controlling physical inventory counting. It is important for the auditor to know beforehand how the inventory count will be conducted so as to assess its effectiveness.
- The nature of internal control related to inventories at different locations. It is possible that inventories at one location have unsatisfactory control leading to higher risk of material misstatement related to inventories at that particular location.

(c) The auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing of appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

(d) Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. Engagement quality control review is mandatory for all audits of financial statements of **listed entities.**

In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

5. (a) In the given situation, ₹ 60 lacs is accumulated in Electronic credit ledger of WTE Private Limited as finished product is liable to lower GST rate whereas input raw materials for manufacturing carry higher GST rate. It is refundable to company by virtue of provisions of GST law. The above balance would be reflected and classified under current assets. Within current assets, it would be classified into "Other current assets".

Few audit procedures to be performed for verification of above balance are:

- In relation to balances with statutory authorities like GST input credit, prepare a reasonability analysis with respect to purchases by applying the applicable rate to the purchases and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity.
- Obtain copies of statutory GST returns filed on GST portal.
- In case refundable amount as on balance sheet date is still outstanding, verify whether the amount recorded as per books of account tallies with the claim made with the authorities subsequently by going to GST portal.
- In case refundable amount as on balance sheet date is received subsequently, verify it from Bank statement.

(b) For the purpose of identifying and assessing the risks of material misstatement, the auditor shall:

(i) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements.

(ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.

(iii) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test and

(iv) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

(c) **Verification of inventories in the nature of food and beverages:** The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following may be noted in this regard:

(a) All movement and transfer of inventories must be properly documented.

(b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.

(c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.

(e) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

(d) The Principle of Professional Behaviour requires an accountant to comply with relevant laws and regulations and avoid any conduct that the accountant knows or should know might discredit the profession. A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

Example

A Chartered Accountant has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Failure to reply to professional body smacks of lack of courtesy and professional responsibility. In the given case, Chartered accountant has not followed principle of Professional Behaviour.

6. (a) In accordance with SA 610, the external auditor shall not use internal auditors to provide direct assistance to perform procedures that relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

In the given situation, valuation of trade receivables is assigned as an area of higher risk by statutory auditor. Judgment required in checking of accuracy of aging of trade receivables is limited. Therefore, external auditor can assign the checking of the accuracy of the aging to Chief Internal Auditor providing direct assistance as it involves limited judgment.

However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to Chief Internal Auditor providing direct assistance.

(b) **Expenditure Audit:** The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. These standards are—

(i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against ‘rules and orders’.

(ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.

(iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.

(iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.

(v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

OR

(c) The special steps involved in the audit of receipts from sale of tickets are stated below-

(i) Verify that entrance to the cinema-hall during show is only through printed tickets;

(ii) Verify that they are serially numbered and bound into books. In case bookings are made online, verify the system for online booking;

(iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(iv) Verify that for advance booking a separate series of tickets is issued;

(v) Verify that the inventory of tickets is kept in the custody of a responsible official.

(vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(vii) Verify that a record is kept of the ‘free passes’ and that these are issued under proper authority.

(viii) Reconcile the amount of Tax collected with the total number of tickets issued for each class.

(ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(d)

Column A (Description of control in an automated environment)	**Column B (Type of control)**
Reasonableness checks	Application controls
Controls over Data centre and network operations	General IT controls
Controls over application system acquisition, development and maintenance	General IT controls
Program change controls	General IT controls

(e) Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise-

(a) The importance to audit quality of:

(i) Performing work that complies with professional regulatory and legal requirements

(ii) Complying with the firm's quality control policies and procedures as applicable

(iii) Issuing auditor's reports that are appropriate in the circumstances and

(iv) The engagement team's ability to raise concerns without fear of reprisals.

(b) The fact that quality is essential in performing audit engagements.

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PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Division A-Multiple Choice Questions

Case Scenario 1

Question No.	Answer	
1.1	**(b)**	(ii), (iv) and (iii)
1.2	**(c)**	No. The amount should not be recognised as liability. But it needs to be disclosed in the notes to accounts.
1.3	**(a)**	Valuation
1.4	**(b)**	Rights and obligation
1.5	**(d)**	The company was required to restate said amount in accordance with requirements of AS 11. The auditor had verified valuation assertion.

Case Scenario 2

Question No.	Answer	
2.1	**(c)**	The auditor should not accept such an engagement.
2.2	**(c)**	(iii) and (iv)
2.3	**(d)**	A modest change in nature or size of the entity's business
2.4	**(d)**	It was unethical on part of outgoing auditors for failing to respond to communication made by incoming auditors. It is violation of principle of professional behaviour governing professional ethics.

Case Scenario 3

Question No.	Answer	
3.1	**(d)**	Amount of ₹ 0.92 lac is required to be classified under current liabilities in financial statements of firm. Procedure of confirming balance directly from the bank alone is not likely to constitute sufficient appropriate audit evidence.
3.2	**(a)**	She should verify subsequent sale invoices of inventory items lying in stocks as at year end. Besides, she should also review

		stock records of year 2022-23 and subsequent period. Such evidence may constitute sufficient appropriate audit evidence.
3.3	**(c)**	Only debit notes issued by firm on debtors for GST short charged earlier during the year and credit notes issued by firm during the year on debtors to account for extra price charged in accordance with provisions of GST law are examples of internal evidence. Audit evidence obtained by auditor is persuasive.

General MCQ's

1. (c)

2. (c)

3. (a)

Division B -Descriptive Answers

1. (a) Audit Sampling refers to the application of audit procedures to less than 100% of items within a population relevant under the audit such that all sampling units (i.e. all the items in the population) have an equal chance of selection.

In the given situation, senior team member is not selecting items for testing by means of audit sampling. He is only selecting **specific items from a population.** In accordance with SA 500, one of the means available to auditor for selecting items for testing is "by selecting specific items."

Specific items selected may include: -

- **High value or key items:** The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- **All items over a certain amount:** The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- **Items to obtain information:** The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

Therefore, Sanjeev's understanding is not proper.

The above approach for selecting items for testing is subject to non-sampling risk. Non-sampling risk is the risk that auditor may reach an erroneous conclusion for any reason not related to sampling risk. Like, erroneous conclusion may be reached due to some inappropriate audit procedure.

(b) In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following: -

(i) Amounts are included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.

(ii) Advances represent amount due to the bank branch.

(iii) Amounts due to the bank branch are appropriately supported by loan documents and other documents as applicable to the nature of advances.

(iv) There are no unrecorded advances.

(v) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.

(vi) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

(vii) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

(c) Subsequent events are events occurring between the date of financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.

In the given case, the company had already made provision of ₹ 10 lakhs in financial statements for year 2022-23. However, there is an out of court settlement between the company and employee for ₹ 6 lakhs.

It is an example of event which provides evidence of conditions that existed at the date of financial statements i.e. 31st March, 2023. It provides evidence on adjustment in provision amount already made in financial statements. Therefore, internal auditor should ask management to revise provision downwards to ₹ 6 lakhs so that financial statements are in accordance with applicable accounting standards.

(d) As given above, the engagement involves gathering of sufficient appropriate evidence on the basis of which limited conclusion can be drawn up. It is a limited assurance engagement like review. Other two features of such type of engagement are: -

(1) It provides lower level of assurance than reasonable assurance engagement.

(2) It performs fewer procedures than reasonable assurance engagement.

2. (a) Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

(I) Preparation of the financial statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.

Due to its responsibility for the preparation and presentation of the financial statements and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

(II) Information provided and completeness of transactions

The auditor shall request management to provide a written representation that: -

(i) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and

(ii) All transactions have been recorded and are reflected in the financial statements.

(b) Prior to auditor's identification and assessment of risks of material misstatement, planning includes the need to consider following matters:

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

(c) In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cut-off.

(d) Internal Control Questionnaire

- Are competitive quotes obtained from different insurers?

- Is comprehensive insurance cover obtained for fire, flood, burglary, earthquake risks etc.?
- Are all three locations in city A and B covered?
- Are all assets consisting of building, plant & machinery and inventories covered?
- Is there an adequate procedure to ensure that assets acquired between two renewal dates are also covered by insurance?
- Is there an official who decides on value for which policies are taken?
- Does officer who decides on policy value review periodically adequacy of insurance cover?
- Is loss-of-profits insurance cover taken?
- Have there been any instances of rejection of claims?
- Are pending claims followed-up with insurers?

3. (a) The above disclosure is not in accordance with requirements of Division I of Schedule III of Companies Act, 2013. The discrepancies are as under: -

(1) The Company has wrongly disclosed information for trade receivables in a manner which is applicable for trade payables.

(2) No distinction between MSME and other trade receivables is required.

(3) Trade receivables are to be categorised into undisputed and disputed trade receivables as under: -

- Undisputed trade receivables considered good
- Undisputed trade receivables considered doubtful
- Disputed trade receivables considered good
- Disputed trade receivables considered doubtful

(4) Aging is to be reflected for each of above categories in respect of outstandings for the following periods from due date of payment

- for less than 6 months
- 6 months-1 year
- 1- 2 years
- 2-3 years
- more than 3 years

(5) Following information is also required to be disclosed: -

Trade receivables shall be sub-classified as:

(a) Secured, considered good

(b) Unsecured, considered good

(c) Doubtful.

(6) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(7) Debts due by

- directors or other officers of the company or any of them either severally or jointly with any other person or
- firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

(b) Audit procedures to verify existence and valuation assertions for work-in-progress are as under: -

- Attend inventory count in accordance with SA 501 and understand how work in progress is arrived at.
- Evaluate work of management expert, if any, in this regard.
- Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
- Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- Ensure that material costs exclude any abnormal wastage factors.

(c) The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances are given under: -

➢ The entity's timetable for reporting

➢ Organization of meetings to discuss of nature, timing and extent of audit work with management

➢ Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report

➢ Discussion with management regarding the expected communications on the status of audit work throughout the engagement.

➢ Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

(d) One of the factors affecting the form, content and extent of audit documentation relates to size and complexity of audit. Other factors are:

1. The nature of the audit procedures to be performed.
2. The identified risks of material misstatement.
3. The significance of the audit evidence obtained.
4. The nature and extent of exceptions identified.
5. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
6. The audit methodology and tools used.

4. (a) It is important to carry out Tests of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

- Only bona fide sales lead to trade receivables.
- All such sales are made to approved customers.
- All such sales are properly recorded in the books of accounts.
- Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
- Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
- Debtors are collected on time.
- In case debtors are not collected in time, sending reminders and taking legal actions if required.
- Balances are regularly reviewed.
- A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.

(b) Factors to be considered to form an opinion:

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

(1) whether sufficient appropriate audit evidence has been obtained

(2) whether uncorrected misstatements are material, individually or in aggregate.

(3) The evaluations required

(i) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

(ii) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

(c) Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

Therefore, nature of financial reporting itself is one of causes inherent limitations of audit.

(d) As per Standard on Auditing (SA) 705 "Modifications to the Opinion In The Independent Auditor's Report", the objective of the auditor is **to express clearly an appropriately modified opinion** on the financial statements that is necessary when:

(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5. (a) Audit of borrower client of bank carried out at bank's request to verify borrower's current assets- **Stock audit**

Limit up to which an entity can withdraw from sanctioned working capital limit- **Drawing power**

Statutory right of a creditor to adjust debit balance in debtor's account against any credit balance lying in another account of debtor- **Set-off**

Creation of security in a bank branch by mere delivery of title deeds by a prospective borrower of funds- **Equitable Mortgage**

(b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

1. Assessing risks of material misstatement of the financial statements
2. Determining materiality in accordance with SA 320
3. Considering the appropriateness of the selection and application of accounting policies
4. Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions
5. Developing expectations for use when performing analytical procedures
6. Evaluating the sufficiency and appropriateness of audit evidence obtained such as the appropriateness of assumptions and of management's oral and written representations.

(c) Fee from Students:

The fees concessions have to be under proper authority of college management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

Other points to verify fee from students are :

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal control which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
3. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
5. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.

6. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

(d) The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent. Such a letter includes:

(a) The objective and scope of the audit of the financial statements

(b) The responsibilities of the auditor

(c) The responsibilities of management

(d) Identification of the applicable financial reporting framework for the preparation of the financial statements and

(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

6. (a) Risk of Material Misstatement – Greater for Significant Non-Routine Transactions:

Significant risks often relate to significant non- routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

(a) Greater management intervention to specify the accounting treatment.

(b) Greater manual intervention for data collection and processing.

(c) Complex calculations or accounting principles.

(d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Keeping in view above, view of Auditor of Sunshine Ltd is correct.

(b) While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not following the standard instructions/ procedures specified in relation to various aspects of sales as stipulated by the management. It should explain that such a significant deficiency can lead to misstatement of revenue and trade receivables impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

OR

(c) Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(a) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(c) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

(d) The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures helps auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under: -

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

(e) Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹ 1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

Mock Test Paper - Series I: July, 2024

Date of Paper: 2nd August, 2024

Time of Paper: 2 P.M. to 5 P.M.

INTERMEDIATE: GROUP – II

PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Part I -Multiple Choice Questions

1. (a)

2. (c)

3. (a)

4. (b)

5. (b)

6. (d)

7. (c)

8. (a)

9. (b)

10. (a)

11. (b)

12. (b)

13. (c)

14. (b)

15. (b)

Part II -Descriptive Answers

1. (a) The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. One of the factors to be taken into consideration while establishing audit strategy relates to ascertaining of reporting objectives of engagement to plan the timing of the audit and the nature of the communications required. Some of the instances are given under:

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report

- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

In the given case, working paper highlights that auditor has taken into account expected timelines to plan the audit and nature of the communications required. Since the working paper relates to the statutory audit of a company, the ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications.

(b) **(i)** In the given case, risk of material misstatement has been assessed as high in respect of assertions relating to revenue and various direct expenses due to increase in gross profit ratio of company from 14% in year 2022-23 to 24% in year 2023-24.

Few possible reasons which could have led to abnormal jump in gross profit ratio include: -

- Overvaluation of inventories
- Overstatement of revenues
- Understatement of direct expenses

(ii) SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Tisha is of a view that detection risk in this engagement should be kept at high level whereas in the given situation, risk of material misstatement has been assessed as high for assertions relating to revenue and direct expenses. Therefore, detection risk has to be kept at low level so that a material misstatement in these assertions does not remain undetected.

Therefore, view of Ms. Tisha is not proper.

(c) As per SA 500, "Audit Evidence", if the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: -

(a) Evaluate the competence, capabilities and objectivity of that expert

(b) Obtain an understanding of the work of that expert and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Before using the work of PQR Associates, management's expert, auditor should ensure that the criteria mentioned above are fulfilled.

2. (a) As per SA 570, "Going Concern", going concern is one of the fundamental accounting assumptions. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

In the given situation, company has reflected net losses in financial statements of last two years but is able to meet its financial commitments signifying its ability to carry on business/trade. The revenue of company is also expected to grow in the coming period. It shows that management has neither the intention nor the necessity of liquidation or of curtailing materially the scale of operations. Therefore, view of the management for following going concern basis of accounting in current year is appropriate.

Further, the significance of going concern is due to its effect on the preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

(b) In accordance with SA 299, "Joint Audit of financial statements", before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, PQR & Associates and MNO & Co., the joint auditors should:

(a) identify division of audit areas and common audit areas;

(b) ascertain the reporting objectives of the engagement;

(c) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;

(d) consider the results of preliminary engagement activities, or similar engagements performed earlier

(e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

(c) Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation. The objective of audit, on the other hand, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of "investigation".

Therefore, Mr. P is right in objecting the use of word "audit" in the proposed assignment.

3. (a) CARO 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except–

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;

(ii) an insurance company as defined under the Insurance Act,1938;

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and

(v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

(b) Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under: -

- Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
  - Compute inventory turnover ratio (COGS/ average inventory)
  - Perform vertical analysis (inventory/ total assets)
  - Compare budgetary expectations vis-à-vis actuals
- Examine non-financial information related to inventory, such as weights and other measurements.
- Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- Verify the clerical and arithmetical accuracy of inventory listings.
- Reconcile physical inventory amounts with perpetual records.
- Reconcile physical counts with ledger control totals.
- Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
- Goods received on a consignment basis have been properly segregated from other items of inventory.

(c) SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Therefore, such leadership responsibilities are required for all engagements and not for audit engagements only.

Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

4. **(a)** In accordance with SA 505, "External Confirmations", the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

(i) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.

(ii) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions.

(iii) A very low exception rate is expected and

(iv) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

Therefore, view of CA X is not correct.

(b) As per SA 210, "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement. Such a letter includes, inter alia, objective and scope of audit of financial statements. The absence of such a letter leads to misunderstanding between auditor and management. As auditor has failed to send engagement letter, the governing body has formed an improper view of objective and scope of audit of financial statements.

By not following requirements of SA 210, CA H is not acting ethically. He has violated principle of professional competence and due care governing professional ethics. This principle requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation and act diligently and in accordance with applicable technical and professional standards. Maintaining professional competence requires awareness of current technical and professional standards. Non sending of engagement letter shows lack of such awareness on part of CA H. Therefore, he has violated said fundamental principle governing professional ethics.

(c) CA D should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

Verification of BRS shall entail the following: -

- Tallying the balance as per bank book to the bank confirmation/ statement.

- Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.
- Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.
- Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

5. (a) Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process, for example:
  - — General monitoring controls (such as oversight of management).
  - — Controls over the prevention and detection of fraud.
  - — Controls over the selection and application of significant accounting policies.

— Controls over significant transactions with related parties.

— Controls over significant transactions outside the entity's normal course of business.

— Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

(b) CA E, the auditor of Zeena Limited, shall obtain an understanding of whether the entity has a process for: -

(a) Identifying business risks relevant to financial reporting objectives

(b) Estimating the significance of the risks

(c) Assessing the likelihood of their occurrence

(d) Deciding about actions to address those risks

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

(c) As per section 72 of the Multi-State Co-operative Society Act, 2002 following persons are not qualified for appointment as auditors of a multi-state co-operative society: -

(a) A body corporate

(b) An officer or employee of the multi-state co-operative society

(c) A person who is a member or who is in employment, of an officer or employee of the multi-state co-operative society.

(d) A person who is indebted to the multi-state co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the multi-state co-operative society for an amount exceeding one thousand rupees.

6. (a) In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains "out of order" in respect of an Overdraft/Cash Credit.

An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or

- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of ₹ 25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet. Therefore, it has become out of order and is required to be classified as NPA.

Under non-performing assets, it would be classified as "Sub-Standard Asset" as it has remained NPA for a period of less than or equal to 12 months.

(b) During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. Examples of the records or the documents that may provide information about related party relationships and transactions are:

1. Entity income tax returns.
2 Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditor's reports.
12. Documents associated with the entity's filings with a securities regulator (e.g. prospectuses).

(c) The view of Sanjana is appropriate. Some disadvantages are there in the use of audit programmes but most of these can be removed by following some concrete steps. The disadvantages are: -

(i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(iii) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(iv) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

OR

It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Therefore, such verification is significant.

Audit procedures that the auditor should follow to verify that the PPE items have been valued appropriately as per generally accepted accounting policies and practices are: -

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 Impairment of Assets.

Mock Test Paper - Series II: August, 2024

Date of Paper: 22nd August, 2024

Time of Paper: 2 P.M. to 5 P.M.

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PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Part I - Multiple Choice Questions

1. **(b)**
2. **(c)**
3. **(c)**
4. **(d)**
5. **(c)**
6. **(b)**
7. **(b)**
8. **(a)**
9. **(a)**
10. **(b)**
11. **(a)**
12. **(a)**
13. **(c)**
14. **(b)**
15. **(d)**

Part II - Descriptive Answers

1. (a) Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

In the given situation, there is a difference in amount to be recorded as well as in disclosure of a financial statement item from what is required in accordance with applicable financial reporting framework. The company should have recorded gross amount of dividend and interest amounting to ₹ 2.00 lakhs and ₹ 3.00 lakhs respectively in its financial statements in accordance with AS 13. Therefore, amount recorded under head “Other income” should have been for ₹ 10 lakhs (2 lakhs+3 lakhs+5 lakhs).

Further, in accordance with disclosure requirements of Schedule III of the Companies Act, 2013, other income shall be classified in the above situation as: -

(a) Interest Income of ₹ 3 lakhs

(b) Dividend Income of ₹ 2 lakhs

(c) Net gain on sale of investments of ₹ 5 lakhs

Few examples of misstatements are:

- Charging of an item of capital expenditure to revenue or vice-versa.
- Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework.
- Selection or application of inappropriate accounting policies.
- Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework.
- Intentional booking of fake expenses in statement of profit and loss.
- Overstating of receivables in the financial statements by not writing off irrecoverable debts.
- Overstating or understating inventories.

(b) In the given case, method of sampling being used in software is known as interval sampling or systematic sampling. It is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval.

Sampling interval = Sampling units in population/Sample size i.e 1000/100

Sampling interval = 10

Records selected = 100

Software would pick every 10th record from 1 to 1000 records.

When using this method, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

Further, partner of CA Z suggested him to select the first 200 sales invoices from the sales book for the last month. He is suggesting him block sampling for sales, this method involves selection of a block(s) of contiguous items from within the population.

(c) Maintaining professional skepticism throughout audit is necessary if auditor is to reduce risks of overlooking unusual circumstances and using inappropriate assumptions in determining the nature, time and extent of audit procedures and evaluating results thereof.

In the given situation, revenue from operations of the company have increased from ₹ 80 crores to ₹100 crores despite its operations being affected by fire for about two months. Further, despite loss of inventories to the tune of ₹ 5 crores, financial statements reflect increase in net profit before tax from 7.5% in year 2022-23 to 10% in year 2023-24. Thus, approach of CA D lacks professional skepticism.

In spite of these unusual circumstances, the auditor has decided to rely upon same tests of details as performed in the previous years. The nature and extent of audit procedures need to be suitably altered considering changed circumstances. He may include substantive analytical procedures to analyse variations and seek necessary explanations from management. In case of doubt about the reliability of information or indications of possible fraud, Standards on Auditing require auditor to determine what modifications or additions to audit procedures are necessary to resolve the matter. CA D, the auditor of a listed company, shall document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

2. (a) Three examples of assurance engagements are as under :-

(i) Audit of financial statements

An audit of financial statements provides reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(ii) Review of financial statements

Review provides lower level of assurance than audit. Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.

(iii) Examination of prospective financial information

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed. Such type of assurance engagement provides a moderate assurance.

(b) **(i)** When the auditor includes an Emphasis of Matter (EOM) paragraph in the auditor's report, the auditor shall:-

(a) include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter"

(b) include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements and

(c) indicate that the auditor's opinion is not modified in respect of the matter emphasized.

(ii) Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter (EOM) paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

(c) The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for CA Y, the auditor, to assume that users: -

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence

(b) Understand that financial statements are prepared, presented and audited to levels of materiality

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

3. **(a)** In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. CA Amrish, the auditor should take into account the adverse comments, if any, on advances appearing in the following:-

- Previous year's audit reports.
- Latest internal inspection reports of bank officials.
- Reserve Bank's latest inspection report.
- Concurrent / Internal audit report.
- Report on verification of security.
- Any other internal reports specially related to particular accounts.
- Manager's charge-handing-over report when incumbent is changed.

(b) The auditor, CA L should read the LLP agreement & note the following provisions: -

(a) Nature of the business of the LLP.

(b) Amount of capital contributed by each partner.

(c) Interest – in respect of additional capital contributed.

(d) Duration of partnership.

(e) Drawings allowed to the partners.

(f) Salaries, commission etc. payable to partners.

(g) Borrowing powers of the LLP.

(h) Rights & duties of partners.

(i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.

(j) Any loans advanced by the partners.

(k) Profit sharing ratio

Reporting Responsibilities of CA L/ concerning the financial statements of Bro Traders LLP is as follows:

The auditor should mention

(a) Whether the records of the firm appear to be correct & reliable.

(b) Whether he was able to obtain all information & explanation necessary for his work.

(c) Whether any restriction was imposed upon him.

(c) Changes may be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include: -

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.

- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

4. (a) Few audit procedures to obtain sufficient appropriate audit evidence to conclude that trade receivables have been valued appropriately are as under: -

- Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the ageing report receivable (both Dr/Cr balance).
- Also, obtain the list of debtors under litigation and compare with previous year.
- Scrutinize the analysis and identify those debtors which appear doubtful; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where any disputes exist.
- He should check if provisions are made at appropriate rates considering recoverability of amounts due.
- Prepare schedule of movements of bad debts – Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.
- Check that write-offs of the receivable balances have been authority appropriate approved by an appropriate authority i.e. the Board of Directors in case of a company.

(b) The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

Audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements. For the purpose of the Standards on Auditing, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

In the given case, CA K is of the view that materiality and audit risk are only considered at planning stage of an audit. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. Thus, the view of CA K is not correct.

(c) The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

5. (a) Under section 143(1) of the Companies Act, 2013 auditor shall inquire into following matters given as under: -

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company

(d) whether loans and advances made by the company have been shown as deposits

(e) whether personal expenses have been charged to revenue account

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

(b) Auditor wants to ensure Completeness and the audit procedures to be followed by him to verify that trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements are as follows:

- The auditor needs to perform the following cut off procedures:
  - For the last 5 invoices received/ recorded at the end of the reporting date (cut off date) and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity;
  - All goods received prior to the period/ year- end should have been booked in the form of purchases and included in trade creditors.
- Test purchases/ expenses on a sample basis selecting the same from the accounts payable ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates.
- Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
- Review subsequent expense vouchers. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.
- For advance received from customers/ revenue received in advance, obtain the customer wise listing along with its ageing and the nature. Enquire from the entity's management if there has been any dispute with the customer and if there is any additional liability to be recorded. For all such advances, the auditor should verify the underlying documentation based on which the entity had received the advance.
- In relation to statutory dues liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses. Example-GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

Similarly, Provident Fund liability for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

Further, the auditor should obtain and verify the challans for deposits made subsequent to the period-end for all statutory liabilities as at the balance sheet date and also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-vis the liability recorded in books of account.

- He shall prepare a complete list of all statutory dues and consider his reporting requirements under CARO,2020.

(c) **(i)** Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable. A predictable relationship is one that may reasonably be expected to exist and continue over time.

In the given case CA M, auditor of a company, has planned to use substantive analytical procedures for testing relationship between sales and cost of sales. Hence, auditor's approach is appropriate in this case.

(ii) Using substantive analytical procedures is also affected by nature of assertion. Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations).

In the given case, CA M has planned to use substantive analytical procedures for testing rights over certain assets forming part of account balances. Such procedures are likely to be less effective in this case.

6. **(a)** PPE have been valued appropriately and as per generally accepted accounting policies and practices:

It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Mr. Vaayu, the auditor should:

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements (Rights and Obligation)

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.
- In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.
- In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

(b) In the given situation, the senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same.The assistant to keep an open mind as follows:

- To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme.
- As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally but are found relevant for the particular concern.
- Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped.
- The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

Thus, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the Company has diversified.

(c) "Date the financial statements are issued" reflects the date on which the auditor's report and audited financial statements are made available to the third parties. The date the financial statements are issued generally depends on the regulatory environment of the entity.

In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report but must also be at or later than the date the auditor's report is provided to the entity.

Therefore, "date the financial statements are issued" can be later than date of providing auditor's report to the entity.

OR

Standard on Quality Control 1 (SQC 1),"Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. Therefore, it is not mandatory for CA N to share audit file with client.

He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.