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.