ANSWERS OF MODEL TEST PAPER 3

INTERMEDIATE: GROUP – II

PAPER – 5: AUDITING AND ETHICS

SUGGESTED ANSWERS / HINTS

Part I - Multiple Choice Questions

1. **(d)**

2. **(d)**

3. **(c)**

4. **(a)**

5. **(c)**

6. **(d)**

7. **(a)**

8. **(a)**

9. **(b)**

10. **(c)**

11. **(c)**

12. **(a)**

13. **(d)**

14. **(c)**

15. **(a)**

Part II - Descriptive Answers

1. **(a)** Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued: As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.

However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

(i) Discuss the matter with management and, where appropriate, those charged with governance.

(ii) Determine whether the financial statements need amendment and, if so,

(iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

In the instant case, ABC Ltd. received an amount of ₹ 5 crore on account of incentives pertaining to year 2023-24 in the month of April 2024 i.e. after finalisation of financial statements and signing of audit report but before the issuance of Financial Statements to stakeholders. The Board of Directors of ABC Ltd. wished to amend the financial statements and requested the CA. Rashmi (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2024.

After applying the conditions given in SA 560, CA. Rashmi can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

(b) Sample Selections Methods:

(i) Stratified Sampling method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

In the given case, Auditor divided the trade receivables in three groups i.e. balances above ₹ 20 lakhs, balances between ₹ 10 lakhs to 20 lakhs and balances below ₹ 10 lakhs and he selected different percentages of items from each group will be considered as Stratified Sampling.

(ii) Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once.

In the given case, the auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year is Block Selection Method.

(c) Scope of Audit in detection of Fraud: In conducting audit of financial statements objectives of auditor, in accordance with SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" 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.

An audit is not an official investigation into alleged wrongdoing. The auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

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

Thus, inclusion of such a clause in the engagement letter is uncalled for and outside the scope of audit.

(d) **Reporting responsibility of the auditor under paragraph 3 of CARO, 2020:** The auditor is required to report as per clause (vii) (a) of Paragraph 3 of CARO, 2020 that whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

Further, the auditor is also required to report as per Clause (vii) (b) of Paragraph 3 of CARO, 2020, where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute).

2. (a) **Inquiries of Management and Others Within the Entity:** After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. Test of controls are performed to obtain audit evidence about the effectiveness of the: -

(i) Design of the accounting and internal control system

(ii) Operation of the internal control throughout the period

In the given case, CA B was performing Re-performance. It involves the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

Other procedures that can be applied while undertaking test of controls are:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

(b) **Vouching /Verification of borrowings from Bank:** The auditor is required to roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following:

- Ascertain that the confirmation asks for all information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, collateral and security interests).
- Send reminders for non-replies.
- Compare the balances as per the confirmations obtained to the books of the accounts. Ask for reconciliations, if there are any differences and test the supporting documents for the reconciling items on a test check basis.
- Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last-mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
- Ascertain the purpose for which loan has been raised and the

manner in which it has been utilised and that this has not prejudicially affected the entity.

(c) Disclosure of Ratios as a part of Additional Regulatory Information as per Schedule III of the Companies Act 2013 and its Rules relating to disclosure are:

(1) Current Ratio,

(2) Debt-Equity Ratio,

(3) Debt Service Coverage Ratio,

(4) Return on Equity Ratio,

(5) Inventory turnover ratio,

(6) Trade Receivables turnover ratio,

(7) Trade payables turnover ratio,

(8) Net capital turnover ratio,

(9) Net profit ratio,

(10) Return on Capital employed,

(11) Return on investment.

Rules relating to disclosures of Ratios: The company shall explain the items included in the numerator and denominator for computing the above ratios.

Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

(d) Relationship between audit strategy and audit plan

- Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy.
- Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented.
- The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.
- Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.
- The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in

consequential changes to the other.

3. (a) (i) **In this case, CA. Amit is trying to understand that whether controls in the LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions:** He is gaining the understanding of the Monitoring of controls component of internal control. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

(ii) In the given situation, CA Amit is trying to understand that whether there exists a proper system of segregation of duties in the company and the person responsible for recording a transaction is different from the person authorising it. He is gaining an understanding of internal control of the company. In particular, he is understanding "control activities". When a person recording a transaction is different from one authorizing it, he gains confidence that there exists a system for preventing misstatements. It helps him in gaining insight into the internal control system of the company.

(b) In the given case, the audit assistant has kept a large chunk of draft inventory sheets and the final inventory sheet in the audit file which is not correct as the auditor is not required to document draft inventory sheets. Auditor should ensure that only final inventory sheets will form part of the audit documentation. Thus, approach of the audit assistant of filing draft and final inventory sheet is not correct.

As per SA 230, "Audit documentation", audit documentation may be recorded on paper or on electronic or other media.

The auditor need not include in audit documentation:

- superseded drafts of working papers and financial statements,
- notes that reflect incomplete or preliminary thinking,
- previous copies of documents corrected for typographical or other errors, and
- duplicates of documents.

(c) 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, these accounts should be treated as 'out of order'.

In the given case, K Ltd. is availing cash credit limit of ₹ 25 crores from LMN Bank Ltd and the drawing power of the company range between ₹ 22 crores and ₹ 25 crores during the year 2023-24. The limit availed by K Ltd. remained less than ₹ 20 crores during all the days of the financial year 2023-24 and the company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters.

Thus, account should be treated as out of order in the books of LMN Bank Ltd. as the outstanding balance in the principal operating account (₹ 20 crore) is less than the sanctioned limit/drawing power (₹ 22 cores and ₹ 25 crores), but there are no credits continuously for 90 days as on the date of Balance Sheet.

(d) Statistical sampling: Statistical sampling is an approach to sampling that has the random selection of the sample units and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Statistical Sampling is more scientific and appropriate as:

Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.

Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of samples can be evaluated and projected on the whole population in a more reliable manner.

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged.

4. (a) Establishing the overall audit strategy- Assistance for the auditor : Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. 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.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as: -

(i) The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters

(ii) The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas

(iii) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates

(iv) How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

(b) In the given situation, JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment and incurred an amount of ₹ 5,70,000 on dismantling of old plant which had become obsolete so that new plant can be set up at the existing location. An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost. The costs of dismantling, removing the item and restoring the site on which it is located referred to as decommissioning will form part of the new Property, Plant and Equipment.

Elements of Cost: The cost of an item of property, plant and equipment comprises:

(i) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(ii) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(iii) the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

(c) **Appropriate and Inappropriate Phrases while drafting an Unmodified Opinion:** When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

(i) In our opinion, the accompanying financial statements **present fairly, in all material respects**, […] in accordance with [the applicable financial reporting framework]; or

(ii) In our opinion, the accompanying financial statements **give a true and fair view of** […] in accordance with [the applicable financial reporting framework].

The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent.

Inappropriate Phrases: When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

(d) Special report to the Registrar: During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance, a special report may become necessary:

(i) Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.

(ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

(iii) Specific examples of mis-management. Decisions of management against co-operative principles.

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

5. (a) Review of the audit programme: There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed.

Audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

In the given situation, Ms. PP & Co., a firm of Chartered Accountants has been auditing the books of accounts of KALI Ltd. for the past 3 years and the Company has recently made major changes in its business policies, therefore, it is very essential to review the audit programme. Thus, contention of the audit manager to adhere with the instructions of following the same audit programme as per routine practice is not correct.

(b) As per SA 500, "Audit Evidence", issued by ICAI, when using the work of a management's expert as audit evidence the auditor should evaluate the competence, capabilities and objectivity of that expert that:

- Whether the expert is employed by the entity or is an outside party.
- Whether the expert is independent in respect of the entity.
- Auditor's previous experience of the work of the expert.
- Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.

The auditor should also obtain an understanding of the work of that expert that:

- Whether the auditor has expertise to evaluate the work of the expert.
- Evaluating the assumptions and methods used by the management.
- Evaluating the nature of internal or external data used by the expert.

(c) **Use of Digital Technology in the conduct of an audit:** Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization.

In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.

- Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.
- By using such tools, auditors can conduct audits in a better way and devote more attention to areas requiring greater focus.

- Digital audit is helping auditors to better identify risks making use of technology.

(d) Audit Engagement Letter: 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 are recorded in a letter or other the suitable form of written agreement. Such an agreement is known as Audit Engagement Letter. 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.

Audit Engagement letter includes: -

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

(2) The responsibilities of the auditor

(3) The responsibilities of management

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

(5) 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.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies, and that management acknowledges and understands its responsibilities.

6. (a) For audit of provisions and contingencies the auditor should:

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Or

(a) **(i)** Meaning of Deficiency in internal control: This exists when -

(1) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or

(2) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

(ii) As per SA 265, 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 transactions with firm in which the directors are interested. It should explain that such a significant deficiency can lead to misstatement of transactions with related party. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

(b) Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law.

In the given situation, CA P, who is a professional accountant in service, and in terms of employment and professional relationships with the employer he is alert to the possibility of inadvertent disclosures of any information outside the employing organization. However, CA P had to divulge the information and documents as evidence in the course of legal proceedings and same was required by law. Therefore, CA. P will not be held responsible for violation of fundamental principle of "Confidentiality" governing professional ethics.

(c) **Positive confirmation request:** A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request or providing the requested information.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party. The exception needs to be assessed to the entire population after analyzing the reason for difference.

In the given situation, the auditor has sent the positive confirmation request for the amount of 4,25,000 to a trade receivable which was outstanding for more than 6 months, however, due to difference between information requested to be confirmed, or contained in the entity's records (i.e. 4,25,000), and information provided by the confirming party (i.e. 4,20,000) is forming situation of exception confirmation.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330 in case a response is indicating an exception.

The company should be asked to investigate and reconcile the discrepancy indicated by the confirming party.

(d) The lease agreement should be examined, and the following points may be noted:

(i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).

(ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

(iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.

(iv) whether the agreement prohibits the lessee from subletting the equipment and authorises the lessor to do so.