

Mock Test Paper - Series II: August, 2024

Date of Paper: 22nd 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. (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 immovable properties held as at the balance sheet date.
- In case the entity has given such immovable 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 immovable 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.