

## PAPER – 5: AUDITING AND ETHICS

### Part I MCQs

#### Case Scenario 1

PKH & Associates, a Chartered accountant firm, is practicing in Mumbai since last two decades. Rahul got the opportunity to work as an article clerk with PKH & Associates. After completion of formalities of article clerk registration, Rahul is placed in the statutory audit team of the firm. CA P, the partner heading audit team, planned to take Rahul in the audit work of M/s Fox India Limited for the financial year 2023-24. Till last year, CA K was the head of the audit team for audit of M/s Fox India Limited. As it is the first assignment of Rahul, he was instructed by the partner to go through the audit file of M/s Fox India Limited for the financial year 2022-23 and familiarize himself with audit procedures and methodology to be followed for upcoming audit assignment.

On-going through the audit file of F.Y. 2022-23, Rahul found revised engagement letter, other working papers relating to MAT & Deferred tax calculations and the following extract on verification of expenses:

Name of concern	M/s. Fox India Limited
Financial Year	2022-23
Prepared by	D (05.05.2023)
Reviewed by	F (06.05.2023)
Approved by	CA K (07.05.2023)

Sr. No.	Nature of Procedure	Extent of Check	Basis of Sample	Done by
1.	Vouch few expense invoices available in record of concern	10%	Random Sampling	D
2.	Trace these invoices into the account books of the concern.	10%	Random Sampling	D
3.	Verify few invoices with the GST data of the concern	10%	Random Sampling	D

Rahul immediately drafted a revised engagement letter for the financial year 2023-24 and also specified the scope of audit to include the following statements:

Statement I: reliability and sufficiency of financial information

Statement II: proper disclosure of financial information,

Statement III: responsibility of an auditor to prepare the financial statements, and

Statement IV: coverage of all aspects of entity relevant to the financial statements being audited.

He thought that it is mandatory to obtain engagement letter every year and handed over revised draft to CA P. CA P is surprised as to why Rahul drafted the same and explained him the situations under which it is necessary to obtain a revised engagement letter.

Before finalizing the audit report of M/s. Fox India Limited for the F.Y. 2023-24, Rahul performed the following procedures regarding subsequent events:

- (i) Obtained an understanding of procedures established by the company to ensure that subsequent events are identified.
- (ii) Inquired management of the company as to whether any subsequent events have occurred which affects the financial statements as on 31.03.2024.
- (iii) Read the entity's latest subsequent interim financial statements.
- (iv) Read the minutes of meetings of M/s. Fox India Limited that have been held up to 31.03.2024.

**Based on the above facts, answer the following Q. Nos. 1 to 4.**

1. Which of the following would not form part of the explanation given by CA P to Rahul?
  - (A) A recent change of senior management
  - (B) A significant change in nature or size of the entity's business
  - (C) Replacement of CA K by CA P
  - (D) A change in legal or regulatory requirements

**(2 Marks)**
2. Which of the statements included by Rahul in revised draft engagement letter is incorrect?
  - (A) Statement 1

(B) Statement II

(C) Statement III

(D) Statement IV

**(2 Marks)**

3. How will you categorize the information pertaining to F.Y. 2022-23 in relation to extract found?

(A) The same was a part of Audit plan

(B) The same was a part of Audit programme

(C) The same was a part of Audit guidelines

(D) The same was a part of Audit procedures

**(2 Marks)**

4. Which of the audit procedure performed (before finalizing the audit report of M/s. Fox India Limited) by Rahul is not as per SA 560?

(A) Procedure (i)

(B) Procedure (ii)

(C) Procedure (iii)

(D) Procedure (iv)

**(2 Marks)**

### Case Scenario 2

CA F has been appointed as an auditor of a manufacturing entity. Pursuant to appointment, CA F planned to assess the risk of material misstatement. During this process, CA F observed that entity has identified various controls to mitigate the risk. The entity has implemented a control (named TARGET) whose objective is to ensure that production systems are processed to meet financial reporting objectives.

On completion of risk assessment procedure, CA F was wandering as to how he can verify the existence of related party relationships and transactions. So, he consulted one of his colleagues, CA Z, who suggested following ways to identify the same:

(i) Information supplied by the entity to regulatory authorities.

(ii) Entity's income tax returns.

(iii) Inventory records maintained by the entity.

(iv) Life insurance policies acquired by the entity.

On-going through the financial statement provided by the entity, CA F observed that the entity has significantly borrowed the amount during the financial year 2023-24. CA F wanted to ensure that all borrowing on the balance sheet represent valid claims by banks or other third parties. Accordingly, he performed the following procedures:

- (i) Reviewed subsequent transactions after the end of the reporting period.
- (ii) Recomputed the interest on borrowing.
- (iii) Reviewed board minutes for approval of new lending agreements.
- (iv) Agreed loan balance and loan payables to the loan agreement.

CA F decided to perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price. For this, CA F scrutinized raw material consumed as per manufacturing account and compared the same with previous years with closing stock. The variations observed were discussed with the management of the entity.

**Based on the above facts, answer the following Q. Nos. 5 to 8.**

5. Control "TARGET" will be categorised in which of the following?
- (A) Data center and network operations
  - (B) Program Control
  - (C) Processing control
  - (D) Application Control
- (2 Marks)**
6. Which of the procedures performed by CA F is suitable for satisfaction of concern regarding borrowing?
- (A) Procedure (i)
  - (B) Procedure (ii)
  - (C) Procedure (iii)
  - (D) Procedure (iv)
- (2 Marks)**
7. Do you agree with all the ways suggested by CA Z to CA F?
- (A) No, suggestion (i) is not correct
  - (B) No, suggestion (ii) is not correct

(C) No, suggestion (iii) is not correct

(D) No, suggestion (iv) is not correct

**(2 Marks)**

8. CA F performed which of the following analytical procedure to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?

(A) Consumption Analysis

(B) Stock Composition Analysis

(C) Trend Analysis

(D) Ratio Analysis

**(2 Marks)**

### Case Scenario 3

GNH & Co., Chartered Accountants, has been appointed as the statutory branch auditors of Chandigarh branch of HFC Bank, a nationalized bank. While carrying out the audit, the following key issues were identified:

**Issue 1:** Consortium Cash Credit Facility granted to X Ltd.: HFC Bank is a consortium member providing cash credit facilities of ₹ 50 crores to X Ltd., with HFC's share being ₹ 10 crores. Over the past two quarters, interest amounting to ₹ 1.75 crores have been debited in cash credit account of X Ltd., while credits in the account amounts to only ₹ 1.25 crores. Despite this shortfall, the account has been classified as performing asset, based on a certificate from the lead bank (UNC Bank Limited).

**Issue 2:** Asset Classification of SJ Ltd.: SJ Ltd.'s account has seen no recovery for the past 18 months. However, the bank has not applied NPA norms or income recognition norms to this account. The management justifies this by stating that the account is guaranteed by the Central Government and that NPA and income recognition norms are not applicable. Government has not invoked the guarantee.

**Issue 3:** Loan Application from ABC Traders: ABC Traders has applied for a cash credit limit from HFC Bank for supporting working capital requirements on account of business expansion. In discussions with ABC Traders, HFC Bank has requested different forms of security, depending on the nature of the assets offered, which includes immovable property (warehouse), goods in stock, accounts receivable, and insurance policies. Borrower provided the security and was sanctioned cash credit limit of ₹ 4.50 Crores.

**Issue 4:** Precision Engineering (one of the borrowers of the branch) has utilized the entire sanctioned cash credit limit of ₹ 300.00 Lacs. Outstanding balance as on 31 March, 2024 is ₹ 308.00 Lacs. Bank classified the account as Substandard Asset. One fine day DGM (Inspection) of Bank was passing through the area in which borrower is located and observed that building occupied by the borrower is damaged and there is no machinery, stock and other assets available in the premises. Borrower was not available telephonically and no contact could be made with him. He ordered independent verification of assets and report was submitted that no security mortgaged with bank is available. Report has been accepted by the bank authorities. Only a piece of land with realizable value ₹ 25 Lacs is available as of now. Bank made a provision in its books of accounts considering the account as Substandard Asset.

**Based on the above facts, answer the following Q. Nos. 9 to 12.**

9. Whether the asset classification of account of X Limited is correct?
- (A) Classification is correctly done on the basis of certificate provided by UNC Bank Limited.
  - (B) Classification is correctly done subject to confirmation from the Central statutory auditor of the bank.
  - (C) Classification is correctly done subject to confirmation from the Central statutory auditor of the bank and also other parameters specified in the RBI guidelines have been followed.
  - (D) Classification is not in order as classification has to be done on the basis of record of recovery of the HFC Bank only. **(2 Marks)**
10. Is the bank's decision not to apply NPA and income recognition norms to account of SJ Ltd. valid under regulatory guidelines?
- (A) The bank is correct to the extent of not applying the NPA norms for provisioning purposes. However, this exemption is not available in respect of income recognition norms.
  - (B) The bank is not correct for not applying the NPA norms for provisioning purposes. But this exemption is available in respect of income recognition norms.

- (C) *The bank is correct in not applying the NPA norms and income recognition norms as both are not applicable.*
- (D) *The bank is not correct in not applying the NPA norms and income recognition norms as both are applicable. (2 Marks)*
11. *ABC Traders offered its warehouse as security for the loan. HFC Bank created a charge on the warehouse. Which form of security has been created and whether bank is required to get stock audit done of cash credit account of ABC Traders ?*
- (A) *Security created is Pledge and bank is required to get stock audit done of cash credit account of ABC Traders.*
- (B) *Security created is Mortgage and bank is required to get stock audit done of cash credit account of ABC Traders.*
- (C) *Security created is Pledge and bank is not mandatorily required to get stock audit done of cash credit account of ABC Traders.*
- (D) *Security created is Mortgage and bank is not mandatorily required to get stock audit done of cash credit account of ABC Traders. (2 Marks)*
12. *Whether correct classification and provisioning norms have been applied in the account of Precision Engineering?*
- (A) *The account is correctly classified but provision should be made for hundred percent of the unsecured portion besides making specified provision on secured portion.*
- (B) *The account should have been classified as Doubtful asset and besides making required provision on secured portion, provision should have been made for hundred percent of the unsecured portion.*
- (C) *The account should have been classified as loss asset and full provision should have been made in the books of accounts.*
- (D) *The account should have been classified as Doubtful asset and full provision should have been made in the books of accounts. (2 Marks)*
13. *Which of the following statements is not correct about Limited Liability Partnership (LLP)?*

- (A) An LLP is required to maintain Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold.
- (B) An LLP is called small LLP, the Turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees (₹ 40,00,000) or such higher amount, not exceeding fifty crore rupees, as may be prescribed;
- (C) Every LLP would be required to file annual return in Form 11 with ROC within 30 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- (D) The auditor may be appointed by the designated partners of the LLP at any time for the first financial year but before the end of first financial year. **(2 Marks)**

14. In case any intangible asset is not in active use by the entity, the auditor should check whether: -

- (A) The deletion with respect to the intangible asset has been recorded in the books of accounts post-approval by the entity's management.
- (B) The amortization charge has ceased beyond the date of deletion.
- (C) The deletion with respect to the intangible asset has been recorded in the books of accounts post-approval by the entity's management and the amortization charge shall be continued.
- (D) The deletion with respect to the intangible asset has been recorded in the books of accounts post-approval by the entity's management and the amortisation charge has ceased beyond the date of deletion.

**(2 Marks)**

15. Management of ECX Systems Limited acknowledged that going concern assumption will not be suitable while preparing financial statements and informs the auditor that the fact of uncertainty related to going concern would suitably be disclosed in the notes of accounts. How should the auditor address this while preparing Independent Auditor's Report?



- (A) To include a separate section under the heading "Material uncertainty related to Going Concern" in the auditor's report as per the requirement of SA 570.
- (B) To include a separate section under the heading "Key Audit Matters" in the auditor's report as per the requirement of SA 701.
- (C) To include a sub section under the heading "Material uncertainty related to Going Concern" under separate section of "Key Audit Matters" in the auditor's report as per the requirement of SA 705.
- (D) To include a separate section under the heading "Key Audit Matters" in the auditor's report as per the requirement of SA 570. **(2 Marks)**

**Answer Key**

MCQ No.	Correct Option
1.	(C)
2.	(C)
3.	(B)
4.	(D)
5.	(A)
6.	(C)
7.	(C)
8.	(A)
9.	(D)
10.	(A)
11.	(D)
12.	(C)
13.	(B)/(C)
14.	(D)
15.	(A)

**Part II Descriptive Questions**

Question No.1 is compulsory.

Attempt any **four** questions from the remaining **five** questions.

**Question 1**

(a) AP & Co., Chartered Accountants, are appointed as statutory auditor of Heavy Industries Limited, a listed company engaged in manufacturing of electric vehicles, for the F.Y. 2023-24. As per the recent guideline issued by the regulatory authority, every listed company is required to maintain the digital database of all those personnel who could access the books of the company to avoid Insider Trading. In case of non-compliance, hefty fines may be imposed on the company. CA P is the engagement partner from auditor firm for the audit of Heavy Industries Limited. During planning, CA P planned that he would inquire from in-house IT Head of the company about the maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines. In the light of above facts, explain :

(i) Whether CA P is required to consider about the maintenance of digital database while framing audit strategy ? **(3 Marks)**

(ii) Whether the procedures planned by CA P are in line with SA-300 ?

**(2 Marks)**

(b) Fashion Garments Limited (FOL) is a company engaged in the manufacturing and sale of ready-made garments. The products manufactured by FGL cater to clothing requirements of men, women and kids section. Pearl & Associates, Chartered Accountants, is the statutory auditor of FGL. Partner CA Pearl asked her audit assistant to go through the segment information disclosed and presented in the financial statements. Assistant is new to the audit engagements and seeks her guidance on what is the key responsibility of the auditor in relation to segment information.

What should CA Pearl guide the assistant on the said matter ? **(2 Marks)**

What audit procedures should CA Pearl perform to ensure that methods used by the management to present segment information are in accordance with the applicable financial reporting framework ? **(3 Marks)**

- (c) *Spare Parts Limited received an input from internal auditors that internal controls implemented by the company appears to be reasonable but not so strong that any fraudulent activity can be prevented or timely detected by such controls. Accordingly a qualified person should head the internal controls department. CA Raj has been appointed as an Internal Control Head of the company. His scope of work includes development of internal controls in various departments/areas of the company. On his joining, he studied the various verticals and after identifying the important areas (prone to fraud) implemented strong controls in those areas. In his meeting with senior management and statutory auditors, he assured that satisfactory control environment exists and fraud cannot happen. Whether existence of a satisfactory control environment can be considered as an absolute deterrent to fraud ?* **(4 Marks)**

**Answer**

- (a) (i) As per SA 300, "Planning an Audit of Financial Statements", the auditor should 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, key resources to be employed to conduct audit.

The auditor shall take following factors into consideration while establishing or framing audit strategy viz. identify the characteristics of the engagement that define its scope, consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts, etc.

In the given situation, the regulatory guideline requires Heavy Industries Ltd., a listed company, to maintain a digital database of all those personnel who could access the company's books to prevent insider trading. Further, hefty fines may be imposed in case of non-compliance with this guideline. Therefore, it is very essential that auditor while establishing overall audit strategy evaluate whether the company maintains such a database and complies with the regulatory requirement.

Thus, in view of above, it can be concluded that CA P should incorporate the assessment of digital database maintenance into the overall audit strategy.

- (ii)** As per SA 300, "Planning an Audit of Financial Statements", planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework, etc.

In the given situation, CA P planned to inquire from in-house IT Head of the company regarding maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines. Inquiry with the IT Head regarding the maintenance of the digital database is an appropriate procedure to understand whether the company complies with the regulations. This inquiry will help CA P in obtaining a general understanding of the legal and regulatory framework applicable to the company and how the entity is complying with that framework and other risk assessment procedures.

Thus, the planned inquiry with the IT Head is in line with SA 300.

- (b)** As per SA 501, "Audit Evidence-Specific Considerations for Selected Items", the auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:
- (1) Obtaining an understanding of the methods used by management in determining segment information, and
  - (2) Performing analytical procedures or other audit procedures appropriate in the circumstances.

The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.

Further, audit procedure performed by CA Pearl to ensure methods used by the management to present segment information are in accordance with the applicable financial reporting framework should include:

- Sales, transfers and charges between segments, and elimination of intersegment amounts.
  - Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
  - The allocation of assets and costs among segments.
  - Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.
- (c)
- Existence of a satisfactory control environment is not an absolute deterrent to fraud. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement.
  - However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.
  - Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorised transactions to be processed.
  - The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls.
  - For example, the monitoring of controls and the operation of specific control activities and thereby, the auditor's assessment of the risks of material misstatement.

### Question 2

- (a) *XYZ Ltd., a manufacturing company engaged in the production of various types of yarn, is planning to expand its operations into a new geographical market and also add new products. Company has prepared prospective*

*financial information to be presented to potential investors and financial institutions to secure funding for the expansion.*

*XYZ Ltd. engages a firm of auditors to conduct an assurance engagement on this prospective financial information. During the engagement, the auditors reviewed the assumptions made by XYZ Ltd.'s management and issued a report.*

*Explain the key differences between prospective financial information and historical financial information. How does this distinction impact the level of assurance provided in an assurance engagement on prospective financial information?* **(5 Marks)**

- (b) *CA H is managing partner of HK & Co., a Chartered Accountant firm, having registered office at Delhi. With the annual task of reviewing whether any threat to independence is observed in the firm, CA H noted down the following observations received from the staff and partners of the firm for the F.Y. 2023-24 :*
- (i) *CA J, partner of the firm, performed statutory audit as well as non - audit engagement for M/s. Take Away Private Limited.*
  - (ii) *CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.*
  - (iii) *The costs of air travel and stay accommodation of family members of audit team for audit of Chennai was borne by the client stationed at Chennai.*
  - (iv) *One of the clients, M/s. Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.*
  - (v) *CA N, partner of the firm, who audited M/s. NM Private Limited became arbitrator for dispute between M/s. NM Private Limited and one of its vendors.*
  - (vi) *CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.*

*You are requested to help CA H in classifying the type of threats to independence in each of the above observation received from the staff and partners of the firm. (3 Marks)*

*In case such threats exist, what should the auditor do? (2 Marks)*

- (c) *FRP & Associates are the statutory auditors of Paint Private Limited.*

*Company is into the business of trading and has operations across India. CA M, partner in charge of the audit, is carrying out the audit procedures with his audit team. He entrusted CA Ravi, one of the team members, the task of obtaining various audit evidences connected with the audit and submit the same to the engagement partner for finalizing the audit report. How can CA M ensure that the evidences collected by CA Ravi during the audit will be sufficient for the purpose of audit or not? (4 Marks)*

#### **Answer**

- (a) Difference between "Historical financial information" and "Prospective financial information": The "Historical financial information" relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The "Prospective financial information" relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

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.

Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future-oriented. The auditor is, therefore, not in a position to express an opinion

as to whether the results shown in the prospective financial information will be achieved.

Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.

Hence, such type of assurance engagement provides only a "moderate" level of assurance.

**(b) Type of Threats to Independence**

S. No.	Situation	Threat to Independence
(i)	CA J, partner of the firm, performed statutory audit as well as non-audit engagement for Take Away Private Limited.	Self-review threats
(ii)	CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.	Self-interest threats
(iii)	The costs of air travel and stay accommodation of family members of audit team for audit Chennai was borne by the client stationed at Chennai.	Familiarity threats
(iv)	One of the clients, Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.	Intimidation threats
(v)	CA N, partner of the firm, who audited NM Private Limited became arbitrator for dispute between.	Advocacy threats



	NM Private Limited and one of its vendors.	
(vi)	CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.	Self-interest threats

When such threats exist, the auditor should –

- (1) Either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguards' measures need to be recorded in a form that can serve as evidence of compliance with due process.
  - (2) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.
- (c)** The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements. Sufficiency is the measure of the quantity of audit evidence.

CA M will ensure that the evidence collected by CA Ravi will be sufficient for the purpose of audit by considering following factors:

- (i) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.
- (ii) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components, namely, inherent risk and control risk at the assertion level. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

- (iii) Size of a population: It refers to the number of items included in the population. Less evidence would be required in the case of smaller, more homogeneous populations but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

**Question 3**

- (a) ABC & Co., a Chartered Accountant firm, has been appointed as the statutory auditors of Pen Private Limited for the F.Y. 2023-24. During audit, one of the team members, Mr. R noticed that Pen Private Limited has purchased software amounting to ₹ 2.00 crore and the said software is not an integral part of the related hardware. Mr. R further observed that Pen Private Limited has conducted some research of an internal project work amounting to ₹ 1.00 crore. Pen Private Limited, following Indian GAAP, has presented the aforesaid details in the Balance Sheet as on 31<sup>st</sup> March, 2024 as follows:

Property, Plant, and Equipment	₹
- Software	2.00 crore
- Research	1.00 crore

Mr. R approached the engagement partner with above details and enquired about the correctness of the presentation made by Pen Private Limited in terms of Schedule III to the Companies Act, 2013. Mr. R further wanted to ensure that all additions to Intangible assets during the year 2023-24 have been recorded appropriately in the financial statements of Pen Private Limited. Guide Mr. R. **(5 Marks)**

- (b) Projects India Limited (PIL) is engaged in manufacturing and trading of disposable glasses and plates used in social gatherings/functions. XYZ & Co., Chartered Accountants, is the statutory auditor of PIL for the F.Y. 2023-24. Analytical procedures carried out by the audit team, headed by CA Z, indicate that company's business is going downward and PIL could achieve only 50% of total revenue of F.Y. 2022-23. Management has not taken any steps to increase the revenue or add new products or customers to stabilize the revenue and profitability. Also the suppliers are demanding cash payment at the time of purchase of raw material. Before finalizing the audit report, audit in charge asked for a cash flow forecast from management for the next

12 months from the end date of financial statements. Keeping in view the above facts, answer the following:

- (i) What can be the likely purpose of CA Z in the above situation? **(3 Marks)**
- (ii) State any two audit procedures in relation to the cash flow forecast likely to be performed by CA Z. **(2 Marks)**
- (c) Singh & Associates, while carrying out statutory audit of Rubber Industries Limited, observed that debtors are not making payments invoice wise. As the debtors constitute sixty percent of the total assets, so auditors requested management to provide external confirmations of all the debtors outstanding for an amount exceeding ₹ 1.00 Lac. However, management resisted and no external confirmations were made available. Auditor firm has decided to disclaim an opinion on the financial statements and seek your guidance on amendments that should be made in the "Basis for Opinion" section and elements required by SA 700 (Revised) which need not to be included in the auditor's report. Guide them suitably. **(4 Marks)**

#### Answer

- (a) Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset. Thus, purchase of software, which is not an integral part of related hardware, amounting to ₹ 2 crore by Pen Private Limited should be presented in the Balance Sheet under the head intangible asset not under the head Fixed Asset.

Further, Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. Therefore, presentation of research amounting to ₹ 1 crore of an integral project work by Pen Private Limited under the head Property, Plant and Equipment as Research is not correct as it should be recognised as an expense.

Audit Procedure for ensuring all additions to Intangible assets during the year have been recorded appropriately in the financial statements of Pen Private Limited:

- For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
- Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on

research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

- Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.
  - Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
  - Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis
- (b) (i)** In the given situation, CA Z indicated that the company's business is going downward and 50% of total revenue is also being achieved, further, no steps are being taken by the management to stabilize the revenue and profitability. Accordingly, auditor in-charge asked for a cash flow forecast from management for the next 12 months to analyse as it is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions. Thus, likely purpose of CA Z in the given situation are:
- (1) to obtain sufficient appropriate audit evidence regarding and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
  - (2) to conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
  - (3) to report in accordance with SA 570.
- (ii)** Audit procedures in relation to the cash flow forecast, and analysis likely to be performed by CA Z are:
- (1) Evaluating the reliability of the underlying data generated to prepare the forecast; and

- (2) Determining whether there is adequate support for the assumptions underlying the forecast.
- (c) In the given situation, since the audit firm has decided to disclaim an opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised) amend the heading "Basis for Opinion" to "Basis for Disclaimer of Opinion; and within this section, include a description of the matter giving rise to the modification.
- Further, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised):
- (i) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
  - (ii) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

**Question 4**

- (a) *PQR & Co., Chartered Accountants, has been appointed as statutory auditor of MGM Ltd. The financial statements of the company have material amount outstanding as debtors. Ageing of debtors is being done by the internal auditors and is given by them in their monthly report. This issue was also discussed with the management. The engagement partner from PQR & Co. decided to give the age wise debtors as per the report of internal auditor due to shortage of time. After the audit report was released, the engagement partner realized that the disclosure of the debtors is misleading and the ageing was not done by the internal auditor on correct principles due to which the provision made against old debtors was wrong. The engagement partner held the internal auditor responsible for this. Is he correct in making statement that the internal auditor is responsible for false provisioning? What considerations PQR & Co. should have undertaken before relying on the work of internal auditor? (5 Marks)*
- (b) *Identify and explain the assertions that the auditor will check by performing the following audit procedures-*
- (i) *Employee benefit expenses do not include the cost of any unauthorised personnel.*

- (ii) All the items of inventory pertaining to the relevant year shall be included regardless of the location.
- (iii) Sales are recorded correctly in the books based on the invoices. Discounts have been properly adjusted or accounted for.
- (iv) The entity owns or controls the inventory recorded in the financial statements. i.e. the purchase invoices have been made in the name of the client.
- (v) Inventory has been recognised at the lower of cost and net realizable value in accordance with AS 2 - Inventories. **(5 x 1 = 5 Marks)**
- (c) NHG & Co., Chartered Accountants, is statutory auditor of M/s Backlog Private Limited (BPL) for the F.Y. 2023-24. BPL is engaged in providing telecom services and received a notice from telecom regulator to deposit fee for violating norms. BPL went into litigation and filed an appeal with telecom appellate authority and the matter is pending for decision as at the end of the financial year. However, the company has disclosed the same in financial statements. Audit team members have completed the audit procedures for the year 2023-24 and are in the process of drafting the audit report. Audit team leader knows that matter of norms violation and pending appeal need to be included in the audit report and seeks your guidance on how to report the matter in the auditor's report. Guide him suitably. **(4 Marks)**

**Answer**

- (a) In the given situation, the engagement partner has taken the age wise debtor report from the reports of the internal auditor due to shortage of time and provided the same in the audit report. However, after the issuance of audit report, engagement partner felt that disclosure of debtors is misleading and ageing was not done on the basis of correct principles due to which wrong provisions are made.

Contention of the engagement partner for holding internal auditor responsible for the same is not correct as the external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement.

Before relying on the work of internal auditor, PQR & Co. should consider the following:

- (i) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination;
  - (ii) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
  - (iii) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work;
  - (iv) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;
  - (v) The level of competence of the internal audit function; and
  - (vi) Whether the internal audit function applies a systematic and disciplined approach, including quality control.
- (b)**
- (i) For Employee benefit expenses do not include the cost of any unauthorised personnel: The auditor will check the occurrence assertion for the same to ensure that transactions recognised in the financial statements have occurred and relate to the entity.
  - (ii) All the items of inventory pertaining to the relevant year shall be included regardless of the location: The auditor will check the cut-off assertion to ensure that all assets and liabilities are reported in the appropriate period.
  - (iii) Sales are recorded correctly in the books based on the invoices. Discounts have been properly adjusted or accounted for: The auditor will check measurement assertion to ensure transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated.
  - (iv) The entity owns or controls the inventory recorded in the financial statements. i.e., the purchase invoices have been made in the name of the client: The auditor will check rights & obligations assertion to

ensure that the entity has the right to assets (i.e. whether the entity has ownership and legal title to assets), and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.

- (v) Inventory has been recognised at the lower of cost and net realizable value in accordance with AS 2 - Inventories: The auditor will check valuation assertion to ensure assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement
- (c) As per SA 501 if the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

Further, as per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", the auditor shall report an uncertainty relating to the future outcome of exceptional litigation or regulatory action.

In addition to above, the auditor's report shall also state whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement as per Section 143(3) of the Companies Act, 2013.

In the given case, M/s BPL received a notice to deposit fee for violating norms. It went into litigation and filed an appeal which is pending for decision as at the end of the financial year. The company has disclosed the same in the financial statements. The auditor should assess that pending appeal requires adjustment in financial statements. He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider the impact on auditor's report and report accordingly.

**Alternative Solution:**

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", the auditor shall



report an uncertainty relating to the future outcome of exceptional litigation or regulatory action under Emphasis of Matter paragraph.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (ii) 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
- (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

#### Question 5

- (a) *Z Ltd. engaged ABC & Co., Chartered Accountants, to conduct its statutory audit for the F.Y. 2023-24. The audit team developed an overall audit strategy and plan to address the risk. During the audit, several significant changes occurred, including the discovery of a material misstatement in inventory valuation and changes in the scope of audit procedures due to an unexpected acquisition by Z Ltd. The audit documentation for Z Ltd. should reflect these changes but the auditor of a company failed to document the audit strategy and the audit plan.*

*As a senior auditor of the firm briefly outline what should be included in the documentation of audit strategy and audit plan and how should the audit documentation address significant changes made during the audit engagement.*

**(5 Marks)**

- (b) *SRP Limited appointed M/s JK & Co. as its statutory auditors. Auditors while carrying out the audit observed that company has entered into a complex transaction having material effect on the financial statements. In order to have realistic information on the said transaction (relevant to the audit), audit team decided to take assistance from those charged with governance. Two of the team members were discussing as to who can be*

*"Those charged with governance" but could not get a fair idea of the same. Can you guide them by explaining the same? (5 Marks)*

- (c) *Helping Hands Co-operative society is working for the welfare of its members since last 10 years. Governing body observed that the society had some idle funds during the F.Y. 2023-24 and considering the equity markets growth, decided to invest the same in blue chip mutual funds. Decision brought fortune and society earned handsome return on the investment made. Auditor of the society however gave a qualified opinion. Management has hired you to guide where they went wrong. Give your comments considering section 32 of the Central Act? (4 Marks)*

**Answer**

- (a) The auditor shall document:

- (i) The overall audit strategy: 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.
- (ii) The audit plan: 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.
- (iii) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes: 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.

**(b)** Who are “Those Charged with Governance”:

- The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.
- For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.
- Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example, in some entities, a supervisory board exists that is separate from executive board.
- In other entities, both supervisory and executive functions are performed by a single board. In some entities, those charged with governance hold positions that are an integral part of the entity’s legal structure. For example, company directors. In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons.
- In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee.
- Such diversity means that it is not possible to specify for all audits the persons with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate persons with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities and some not-for-profit organizations.
- In such cases, the auditor may need to discuss and agree with the engaging party the relevant persons with whom to communicate. In deciding with whom to communicate, the auditor’s understanding of an

entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate persons with whom to communicate may vary depending on the matter to be communicated.

- (c) According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:
- (i) In the Central or State Co-operative Bank.
  - (ii) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
  - (iii) In the shares, securities, bonds or debentures of any other society with limited liability.
  - (iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
  - (vi) In any other moneys permitted by the Central or State Government.

In the given case, Helping Hands Co-operative society invested the funds in blue chip mutual funds due to which auditor gave a qualified opinion. Helping Hands Co-operative society should invest the funds in accordance with Section 32 of Central Act as investment in blue chip mutual funds is not permissible.

### Question 6

- (a) CA P was consulted by one of his friends, Mr. Robin. Robin informed him that he wants to enter in education sector and invest in one of the schools being operated in the city. The operations of the school will be managed by Robin only and the proposed investment will be made once CA P confirms the revenue figures given to him (Robin) by existing management of the school. CA P said that main source of revenue to school is fee from students and that will be verified.

*What special steps are involved in the verification of fees collected from students?*

**(5 Marks)**

- (b) Oval Enterprises Limited (OEL) is under legal obligation to represent its current year's financial statements along with the previous year's financial statements (comparative financial statements). Karan & Associates, Chartered Accountants, has been appointed as the statutory auditor for the year. CA Karan noticed that the last year's financial statements contain an adverse opinion for the financial statement as a whole due to a misstatement

*in the evaluation and disclosure of the debtors. Guide CA Karan for his duty regarding the treatment and addressing the issue while drafting his audit report. What disclosures he is required to make in this regard? (5 Marks)*

- (c) *Identify and explain the fundamental principles being referred to in the following cases.*
- (i) *Professional accountants should act diligently and in accordance with applicable technical and professional standards while providing professional services. (2 Marks)*
  - (ii) *A professional accountant shall not knowingly be associated with reports where he believes that the information contains a materially false or misleading statement. (2 Marks)*

OR

- (c) *In an automated environment, there are generally four types of audit tests available. As a senior auditor, it's crucial to guide your team in selecting the appropriate audit tests based on the situation. Explain the types of audit tests commonly used in an automated setting and provide insights on how to determine when and which tests to apply, emphasizing the role of professional judgment in making these decisions. (4 Marks)*

### Answer

#### (a) Steps involved in the verification of fees collected from students:

- (i) 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 check which ensures that demands against the students are properly raised.
- (ii) 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.
- (iii) 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.

- (iv) 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.
  - (v) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
  - (vi) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
  - (vii) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.
- (b)** In the given case, CA Karan noticed that the last year's financial statements contain an adverse opinion for the financial statement whole due to a misstatement in the evaluation and disclosure of the debtors. If the auditor's report on the prior period, as previously issued, included an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
- (i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
  - (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

Further, when comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- (i) That the financial statements of the prior period were audited by a predecessor auditor;
- (ii) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
- (iii) The date of that report,

**(c) Fundamental Principles:**

- (i) Act diligently and in accordance with applicable technical and professional standards: In the given case, professional competence and due care fundamental principle is being referred to since a professional accountant shall comply with the principle of professional competence and due care, which 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.
- (ii) A professional accountant shall not knowingly be associated with reports where he believes that the information contains a materially false or misleading statement: In the given case, integrity fundamental principle is being referred to, it prescribes that a professional accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.

**OR**

- (c)** There are basically four types of audit tests that should be used are inquiry, observation, inspection and reperformance.

Inquiry is the most efficient audit test, but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file.