

## PAPER – 5: Auditing & Ethics

### Suggested Answers – Sep. 2024 Exams

#### PART – I

##### Case Scenario – I

M/s KRISH & Company is a firm of Chartered Accountants based in Punjab. CA K, CA R, CA I, and CA SH are the partners of the firm. The firm is engaged in various audit assignments. The engagement partners, who were handling their respective assignments for the financial year 2023-24, dealt with the following issues raised during the course of their respective audits.

- M/s KRISH & Co. is appointed as the joint auditor along with M/s. PK and Associates and M/s. RS and Associates for the audit of a large manufacturing company for the financial year 2023-24. CA K is in charge of this audit. They have divided their audit areas and have also identified the common audit areas, which will be applicable to all the joint auditors. While forming the opinion, CA K had a different opinion whereas, the other two audit firms shared the same opinion. Both of them contended that as they were forming a majority, M/s KRISH & Co. will have to agree with their opinion.
- CA R is conducting the statutory audit of PAWAN Ltd. He observed that, during the year, the company has issued shares at premium and has transferred the amount received as premium to securities premium account. He wants to ensure that PAWAN Ltd. has utilised the amount available in the securities premium amount for the purposes permitted under the Companies Act, 2013.
- Registrar of Co-operative Societies has appointed M/s KRISH & Co. as the statutory auditor of NAND Co-Operative Society for the financial year 2023-24. CA I is looking after the audit of the said registered society. During the year, in terms of Section 34 of the cooperative societies Act, with the sanction of the Registrar, Society has contributed for charitable purposes as defined in section 2 of the Charitable Endowments Act, 1890. CA I is ensuring whether requirements, as regards contribution made, have been complied with.
- All the engagement partners and the audit team of M/s KRISH & Co. have deliberations and discussions every week through google meet to review the progress of their respective assignments. During last such meet, CA SH, the managing partner, briefed to the team about the form, content, and extent of audit documentation in terms of SA 230, while citing examples of records to be excluded as well as to be included as a part of audit documentation.

Based on the above facts, answer the following questions: (Q. No. 1 to Q. No. 4)

1. The securities premium account of PAWAN Ltd. cannot be applied for which of the following purposes?
  - (a) In writing off the debit balance in the Profit & Loss account.
  - (b) In writing off the expenses of, or the commission paid or discount allowed on any issue of equity shares of the company.
  - (c) For the purchase of its own shares or other securities under section 68.
  - (d) In paying up unissued equity shares of the company to be issued to the members of the company as fully paid bonus shares.

**(2 Marks)**

2. CA I, who is in charge of audit of NAND Co-Operative Society, wants to ensure that the society has contributed for charitable purposes within the limits prescribed. How much is the society allowed to contribute for charitable purposes?
- (a) contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund.
  - (b) contribute an amount at the appropriate rate as per class of the society.
  - (c) contribute an amount not exceeding 20% of the net profits remaining after compulsory transfer to the reserve fund.
  - (d) contribute annually at prescribed percentage of the profits as approved by the General body of the society. **(2 Marks)**
3. Which of the following need not be included by the audit team as a part of audit documentation during handling of their respective assignments?
- (a) Significant and specific contracts and agreements.
  - (b) Draft audit engagement letter.
  - (c) Summaries of significant matters.
  - (d) Checklists. **(2 Marks)**
4. In case of difference of opinion between the joint auditors, what course of action can M/s. KRISH & Co. take while issuing the audit report?
- (a) They will have to agree with the opinion formed by the majority of auditors.
  - (b) They will have to agree with the opinion formed by the majority auditors, but they can mention their view in the Emphasis of Matter Paragraph.
  - (c) They can add a separate audit opinion paragraph in the common audit report.
  - (d) They can issue a separate audit report and the audit reports issued by the joint auditors shall make a reference to each other's audit report.

### **Case Scenario – II**

Mega Power Ltd. is a manufacturer of solar lanterns, which are used in remote villages where there is no reliable supply of electricity. However, due to power projects undertaken by the government, the demand for their solar lanterns has significantly declined over the past few years.

The company was in need of ₹ 2 crores for working capital and other expenses but was not able to fund this amount. Consequently, their suppliers were paid much later than usual and hence some of them withdrew the credit terms, meaning the company had to pay cash on delivery. This created a severe cash crunch and the auditor feels that other than the cash crunch, there are several other financial indicators that cast a significant doubt on the company's ability to continue as a going concern.

The management of the company, however, assures the auditor that this is temporary and the situation will change soon as they are planning to diversify their business. They are ready to provide written representation for the same. The auditor feels that a material uncertainty still exists. The auditor wants the management to make adequate disclosure about this in the financial statements. The auditor wants to include a separate section about this in his audit report. He is also contemplating about the kind of audit report that should be issued.

The auditor has concerns about ethical values and diligence of management. He is concerned about the reliability of the representations made by the management and the audit evidence in general. The auditor is of the opinion that the written representations from management are not reliable.

Based on the above facts, answer the following questions: (Q. No. 5 to Q. No. 7)

5. Which kind of audit report will the auditor issue, if the use of going concern basis of accounting is appropriate, but a material uncertainty exists and adequate disclosure of the material uncertainty is made in the financial statements by the management?

- (a) Adverse opinion
- (b) Disclaimer of opinion
- (c) Unmodified opinion
- (d) Qualified opinion

**(2 Marks)**

6. If the auditor is of the opinion that the written representations are not reliable, what kind of audit opinion should be issued by him?

- (a) Disclaimer of opinion
- (b) Adverse opinion
- (c) Unmodified opinion and mention the facts in Other Matters Paragraph
- (d) Unmodified opinion and mention the facts in Emphasis of Matter Paragraph

**(2 Marks)**

7. Financial events or conditions that may cast significant doubt on the entity's ability to continue as a going concern does not include.

- (a) Inability to comply with the terms of loan agreements.
- (b) Inability to pay creditors on due dates.
- (c) Shortage of important supplies.
- (d) Substantial operating losses.

**(2 Marks)**

8. RDB & Co. have been appointed as statutory auditors of INA Group of hotels. This is the first time the firm is auditing an industry in food & beverage. The engagement partner, CA R, and other key members of the engagement team have undertaken the activity of development of an audit plan of INA Hotels after thorough understanding the Hotel's business and its environment. As per SA 300, description of which of the following matters is not a part of developing an audit plan?

- (a) The nature, timing and extent of planned risk assessment procedure.
- (b) The nature, timing and extent of planned further audit procedures at assertion level.
- (c) The nature, timing and extent of resources necessary to perform the engagement.
- (d) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

**(2 Marks)**

9. The Board of Directors of a company wanted the auditor to certify Export sales during the year for submitting to the authorities. The auditor also signed the Confirmation letters to be sent to various debtors and creditors for confirming their balances as on 31.03.2024.

UDIN is required to be generated by the auditor for:

- (a) Export sales during the year certificate only.
- (b) Confirmation letters only.

(c) Both Export sales during the year certificate and Confirmation letters. (D) No UDIN is required to be generated.

(d) No UDIN is required to be generated.

**(2 Marks)**

10. M/s DEF & Associates have been appointed as the statutory auditor of JKL Ltd. for the first time for the financial year 2024-25. The engagement partner, CA D, is briefing his engagement team about the need of Engagement Standards and quality control standards in the areas of financial statement audits and in other types of assurance services. Out of the following which one point is not correct about why standards are needed?

(a) Standards equip professional accountants with professional knowledge & Skill.

(b) Standards ensure audit quality.

(c) Standards promote uniformity as audit of financial statements is carried out following these Standards.

(d) Standards ensure carrying out of audit against established benchmarks at par with local practices.

**(2 Marks)**

### **Case Scenario – III**

GHB Ltd., a listed company, having its registered office at New Delhi, is in the business of blending, processing, packing and selling various brands of Tea. BPP & Co. LLP, Chartered Accountants, are appointed as the statutory auditors of the company for the financial year 2023-24. CA B is the engagement partner for the assignment.

The company has a centralised warehouse near the border of Himachal Pradesh. CA B's attendance, on 31st March, 2024, at the physical inventory counting in respect of the said warehouse became impracticable on account of natural calamity in that area. It also became impossible for CA B to perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory.

The company had spent huge amount on employee benefits. Hence, CA B instructed his assistants to test the controls that the company had set around the employee benefit expenses. After being satisfied with the controls maintained by the company, he instructed his team to bifurcate the employee benefit expenses into salaries and wages, contribution to PF, expenses on ESOP/ ESPP and staff welfare expenses.

The engagement partner CA B, while evaluating, validating and reporting on the design and efficiency of internal financial controls at GHB Ltd., also impressed upon the directors, independent directors and the audit committee the way in which the Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls of a company.

Due to time constraints, CA B is under pressure to issue a clean report in the limited time frame. He has insufficient time to properly perform or complete the relevant duties and issue appropriate audit report.

The Board of Directors want CA B to certify the debtors to be sent to the bank without checking. CA B agrees, as most of the professional income of BPP & Co. LLP comes from GHB Ltd. They have undue dependence on the fees from GHB Ltd. hence; they are concerned about losing the engagement.

Based on the above facts, answer the following Q. Nos. 11 to 15.

11. Which assertion concerning the bifurcation of employee expenses into various heads is being verified by CA B?
- (a) Occurrence
  - (b) Measurement
  - (c) Completeness
  - (d) Disclosures
- (2 Marks)**
12. With reference to reporting on the internal financial controls system under the Companies Act, 2013, which of the following does not fall within the nature of responsibility of GHB Ltd.?
- (a) In accordance with the terms of reference specified in writing by the Board, act of every audit committee to include evaluation of internal financial controls and risk management systems.
  - (b) Directors' responsibility statement to state that the Directors had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.
  - (c) Board of Directors have to appoint an expert to state that the internal financial controls of the company are commensurate with the size and nature of its business.
  - (d) In terms of code for Independent Directors, independent directors to get themselves satisfied that financial controls and systems of risk management are robust and defensible. **(2 Marks)**
13. Due to tight deadlines, CA B has insufficient time to properly perform or complete the relevant duties and he has to sign off clean audit report. Which fundamental principle governing professional ethics is disregarded by him?
- (a) Professional competence and due care
  - (b) Professional behaviour
  - (c) Integrity
  - (d) Objectivity
- (2 Marks)**
14. Undue dependence on the fees from GHB Ltd. creates which threat of independence for the auditors?
- (a) Intimidation threat
  - (b) Familiarity threat
  - (c) Self-interest threat
  - (d) Advocacy threat
- (2 Marks)**
15. Since it became impracticable for CA B, on 31st March, 2024, to attend physical inventory counting at the warehouse and also became impossible to perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and conditions of inventory, CA B shall:
- (a) Take Management Representation regarding the existence and valuation of inventory and mention in Emphasis of Matter paragraph.
  - (b) Rely on GHB Ltd's perpetual inventory records as audit evidence and express unmodified opinion.

- (c) Omit altogether the audit procedure of physical inventory counting from the audit programme because of impracticability.
- (d) Modify the opinion in the auditor's report in accordance with SA 705 as a result of the scope limitation. **(2 Marks)**

**Answers:**

1. (A) In writing off the debit balance in the Profit & Loss account.
2. (A) Contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund.
3. (B) Draft audit engagement letter
4. (D) They can issue a separate audit report and the audit reports issued by the joint auditors shall make a reference to each other's audit report
5. (C) Unmodified Opinion
6. (A) Disclaimer of Opinion
7. (C) Shortage of Important Supplies
8. (C) The nature, timing and extent of resources necessary to perform the engagement
9. (A) Export sales during the year certificate only
10. (D) Standards ensure carrying out of audit against established benchmarks at par with local practices
11. (D) Disclosures
12. (C) Board of Directors have to appoint an expert to state that the internal financial controls of the company are commensurate with the size and nature of its business
13. (A) Professional competence and due care
14. (C) Self-interest threat
15. (D) Modify the opinion in the auditor's report in accordance with SA 705 as a result of the scope limitation

**For academic updates and related contents:**

- Join telegram channel: <https://t.me/altclasses>
- Visit knowledge portal of [www.altclasses.in](http://www.altclasses.in)

**For books/class related queries:**

- E-mail: [altclasses11@gmail.com](mailto:altclasses11@gmail.com)
- Ph.: 9319805511, 7260941195

**For Online purchase of books/classes:** Visit our web portal: [www.altclasses.in](http://www.altclasses.in)



**PART - II**

**Question No. 1 is compulsory.**

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

**Question 1**

- (a) CA Rashmi is the auditor of ABC Ltd. for the financial year ending 31/03/2024. The audit report for the year was signed by her on 19/04/2024.

On 25/4/2024, the company received a communication from the Central Government that an incentive amount of ₹ 5 crores pertaining to financial year 2023-24 was approved. It was paid to the company before the end of April 2024. The financial statements of the company were not yet issued to the shareholders.

The Board of Directors wished to include the incentive amount in the financial statements and requested the auditor to issue a fresh audit report for the year ended 31/03/2024.

Analyze the issue involved and give an overview of the auditor's responsibility in such a situation.

**(4 Marks)**

- (b) Auditors cannot normally examine all the information available to them as it would be impracticable to do so and using audit sampling will produce valid conclusions. Samples should be selected in such a manner that it is representative of the population from which the sample is being selected.

Which sample selection method is used in the following two cases? Identify and explain them briefly.

- (i) Auditor divided the trade receivables in three groups: balances above ₹ 20 lakhs, balances between ₹ 10 lakhs to ₹ 20 lakhs and balances below ₹ 10 lakhs. He selected different percentages of items from each group.

- (ii) 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.

**(4 Marks)**

- (c) PD & Co., Chartered Accountants, were appointed as the statutory 3 auditors of MR Limited for the financial year 2023-24. MR Limited included the following clause in the appointment letter to the auditors: "The Auditor shall be responsible for detecting the frauds that may happen in the company during the financial year 2023-24."

The auditor objected to inclusion of such a clause in the appointment letter. Discuss in the light of scope of audit.

**(3 Marks)**

- (d) M/s. PQ Limited has a turnover of ₹ 807 crores during the financial year 2023-24. It has outstanding dues towards Goods and Services Tax (GST) of ₹ 10 lakhs since June 2023. When enquired by the auditor, the company's management informed him that they have filed an objection letter for the said demand with the GST Authorities, however, no response is received from the GST Department. State the reporting responsibility of the auditor under paragraph 3, clause (vii) of the Companies Auditor's Report Order, 2020 [CARO, 2020].

**(3 Marks)**

**Answer:**

**(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 crores 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. Board of Directors of ABC Ltd. intends to amend the accounts and requested 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 Selection Method:**

- (i) **Stratified Sampling:** In first case, stratified sampling method is used. This method involves dividing whole population in few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population. Number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata.

- (ii) **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population.

Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.

Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.



**(c) Scope of Audit:**

An Audit of Financial Statements include within its scope the following:

- (1) **Coverage of all aspects of entity:** Audit of F.S. should be organized adequately to cover all aspects of the entity relevant to the F.S.
- (2) **Reliability and sufficiency of financial information:** Auditor should be reasonably satisfied that information contained in accounting records and other source data is reliable and provide sufficient basis for preparation of F.S.
- (3) **Proper disclosure of financial information:** Auditor should decide whether relevant information is properly disclosed in F.S in compliance with applicable statutory requirements.

The objective of audit, 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.

**Conclusion:** Based on this discussion, it can be concluded that auditor is not responsible for detecting the frauds that may happen in the company. Hence, auditor objection for inclusion of such a clause in the appointment letter is correct.

**(d) Reporting under CARO, 2020 regarding Statutory Dues [Para 3(vii)]:**

- Whether the company is regular in depositing undisputed statutory dues including GST, 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 at 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.
- Where statutory dues referred above have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.
- In the given case, company has outstanding dues of GST of ₹ 10 lakhs for which company have filed an objection letter with the GST Authorities, however, no response is received from the GST Department.
- Auditor is required to stated the fact in his report under CARO, 2020 as to the outstanding dues of GST for which company has raised objection with the GST authorities.

**Question 2**

- (a) CA B, was the auditor of Star Limited. He wanted to ensure that the company had correctly reconciled its bank accounts and also wanted to understand whether and how far the internal control system was operating in the company. What kind of test of control was CA B performing? What are the other procedures that can be applied while undertaking test of controls? **(4 Marks)**
- (b) Alfa Limited has availed bank overdraft facility from a nationalized bank. The company received balance confirmation certificate for bank overdraft balance as on 31.03.2024 from the bank.

Particular	Amount (₹)
Bank overdraft balance as per Bank Certificate	25,66,200/-
Bank overdraft balance as per Ledger	26,45,300/-

How will you vouch/verify borrowings from Bank taken by Alfa Limited?

**(4 Marks)**

- (c) Schedule III of the Companies Act, 2013 prescribes disclosure of certain ratios as a part of Additional Regulatory Information. Mention any 3 ratios that should be disclosed along with the Rules relating to disclosure of these ratios. **(3 Marks)**
- (d) The engagement partner, of a firm of auditors, is explaining to his audit team, undergoing practical training, the inter relationship between audit strategy and audit plan. Discuss the points which the engagement partner will explain to his team in this regard. **(3 Marks)**

**Answer:**

**(a) Tests of Control:**

Procedure performed to ensure that the company had correctly reconciled its bank accounts and also wanted to understand whether and how far the internal control system was operating in the company is Re-performance. Re-performance involves performing procedures or controls that were originally performed as part of the entity's internal control.

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

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

**(b) Verification of Borrowings from Banks:**

Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

- (i) 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.
- (ii) 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 RoC and recorded in the Register of charges.
- (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the BoD is authorised to raise a loan or borrow from a bank.
- (iv) Confirm, in the case of a company, that the restraint contained in Sec. 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
- (v) 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.

In the given case, auditor should also ask for reconciliations for the differences in overdraft balance as per Bank Certificate and as per Ledger and test the supporting documents for the reconciling items on a test check basis.

**(c) Disclosure of Ratios:**

Following Ratios to be disclosed as a part of Additional Regulatory Information:

- (i) Current Ratio,
- (ii) Debt-Equity Ratio,
- (iii) Debt Service Coverage Ratio,
- (iv) Return on Equity Ratio,
- (v) Inventory turnover ratio,
- (vi) Trade Receivables turnover ratio,
- (vii) Trade payables turnover ratio,
- (viii) Net capital turnover ratio,
- (ix) Net profit ratio,
- (x) Return on Capital employed,
- (xi) Return on investment.

*(Note: Any three Ratios may be specified)*

**Rules relating to Disclosure:**

- The company shall explain the items included in 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 the Overall Audit Strategy and the 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 NTE of audit procedures to be performed by ET 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.
- 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.

**Question 3**

**(a)** CA Amit is the auditor of LMN Ltd. While conducting the audit, he wanted to analyze the different components of internal control of the company. Identify and explain which component of internal control he is trying to understand in the following two cases: -

- (i) Whether controls in LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions.
- (ii) Whether there exists proper segregation of duties in the company and the person responsible for recording a transaction is different from the person authorizing it. **(4 Marks)**

- (b) M/s. PK & Company, Chartered Accountants, are the statutory auditors of JC Limited. CA Tarun, partner of M/s. PK & Company, was entrusted to supervise and verify the inventory items as on 31.03.2024. During the process of verification, a large chunk of draft inventory sheets were accumulated and then a final inventory sheet was prepared. The audit assistant has kept all these drafts and the final inventory sheet in the audit file. Is the approach of the audit assistant, correct? Which papers/documents may not be included in the audit documentation? **(4 Marks)**
- (c) K Ltd. is availing cash credit limit of ₹ 25 crores from LMN Bank Ltd. The drawing power of the company ranged between ₹ 22 crores and ₹ 25 crores during the year 2023-24. The limit availed by the company remained less than ₹ 20 crores during all the days of the financial year 2023-24. 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. How will this account be classified in the books of LMN Bank Ltd. as on 31-03-2024? Explain. **(3 Marks)**
- (d) You are the statutory auditor of NP Ltd. Looking at the huge size of similar transactions, you directed your team members to use statistical sampling. One of the team members, Mr. Q, wants to select samples based upon his personal experience & knowledge as he is not aware of statistical sampling. You are required to explain to Mr. Q why the use of statistical sampling method is more scientific and appropriate. **(3 Marks)**

**Answer:**

**(a) Components of Internal Control:**

(i) In the first case, auditor is trying to understand **Monitoring of Control**.

Monitoring of controls is a process to assess effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.

Management's monitoring activities may also include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

(ii) In the second case, auditor is trying to understand the **control activities relevant to audit**.

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities relevant to audit generally include policies and procedures relating to

- performance reviews (reviews of actual performance with budgets),
- information processing (for example controls over checking arithmetical accuracy of records, program change controls etc.),
- physical controls (like controls over physical security of assets) and
- segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

**(b) Audit Documentation:**

SA 230 “Audit Documentation” defines the term audit documentation as to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

In the given case, during the process of verification, a large chunk of draft inventory sheets was accumulated and then a final inventory sheet was prepared. The audit assistant has kept all these drafts and the final inventory sheet in the audit file. There was no need to kept all these drafts in the audit file; only final inventory sheet is sufficient.

**Conclusion:** Approach of the audit assistant to kept all drafts and final inventory sheet in the audit file is not correct.

**Papers/documents that may not be included in the audit documentation:**

- (a) superseded drafts of working papers and F.S.,
- (b) notes that reflect incomplete or preliminary thinking,
- (c) previous copies of documents corrected for typographical or other errors, and
- (d) duplicates of documents.

**(c) Classification of Advances:**

- An Advance will be classified as non-performing advance if:
  - (a) It ceases to generate income for a bank; or
  - (b) Interest and/or instalment of principal in respect of such an advance have remain overdue or **out of order** for a specified period of time.
- An account should be treated as ‘Out-of-order’ if:
  - (a) the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
  - (b) there are no credits continuously for 90 days as on the balance sheet date or
  - (c) the credits are not enough to cover the interest debited during the same period.
- In the given case, though outstanding balance remained within the drawing power throughout the year, 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.

**Conclusion:** This account to be classified as non-performing advance in the books of LMN Bank Ltd.

**(d) Use of Statistical Sampling:**

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged. Use of statistical sampling method is more scientific and appropriate due to following features:

- (1) **More Scientific:** 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.
- (2) **Wide Application:** 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.

- (3) **No Personal Bias:** There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

#### Question 4

- (a) EFG Ltd. has appointed M/s. MN & Co., Chartered Accountants, as the statutory auditors for the year 2024-25. CA N, the engagement partner, completed his risk assessment procedure. However, he is concerned about the management of human resources to be employed to conduct the audit. For this purpose, he wants to establish an overall audit strategy for setting the scope, timing and direction of the audit. Describe how the process of establishment of overall audit strategy will assist him in managing deployment of his human resources for various audit areas. **(4 Marks)**
- (b) JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment during the year under audit. They have incurred an amount of ₹ 5,70,000/- on dismantling of an old plant, which had become obsolete, so that a new plant can be set up at the existing location. The Auditor is in the process of verifying the cost incurred towards addition to Property, Plant and Equipment. What should be the accounting treatment of the amount spent on dismantling of old plant in the financial statements? Which elements of cost should be considered for valuing Property, Plant and Equipment? **(4 Marks)**
- (c) CA Ayush has recently qualified and has joined a CA Firm. On going through various audit reports, he observed that different phrases were used to express an unmodified opinion on the financial statements. On enquiring with a senior, he got to know that all those phrases can be regarded as being equivalent. Which phrases are appropriate and which phrases are inappropriate while drafting an unmodified opinion? **(3 Marks)**
- (d) You have been appointed as an auditor of Co-operative society. During the course of audit, you have noticed some serious irregularities in the working of the society. Enumerate those special matters for reporting to the Registrar. **(3 Marks)**

#### Answer:

(a) **Process of establishing the overall audit strategy:**

- 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:
  - (1) 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;
  - (2) 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;



- (3) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- (4) 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) Accounting treatment of amount spent on dismantling of old plant:**

As the expenditure is incurred at the time of setting up of new property, plant and equipment (PPE), dismantling cost need to be capitalized and to be considered as part of cost of PPE.

**Elements of cost to be considered for valuing Property, Plant and Equipment:**

Cost of an item of PPE comprises of:

- (a) its purchase price, including import duties and nonrefundable purchase taxes, after deducting trade discounts and rebates.
- (b) any costs directly attributable to bringing the asset to location and condition.
- (c) initial estimate of costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities.

**(c) Appropriate Phrases for 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:

- (a) In our opinion, the accompanying financial statements **present fairly, in all material respects**, [...] in accordance with [the applicable financial reporting framework]; or
- (b) 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 for Unmodified Opinion:**

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 matters for reporting to the Registrar in case of audit of Co-operative Society:**

During the course of audit, if auditor notices that there are some serious irregularities in working of society, he may report these special matters to the Registrar. Registrar on receipt of such a special report may take necessary action against the society.

**Circumstances in which special report is required:**

- (i) Personal profiteering by members of managing committee in transactions of society, which are detrimental to interest of society.
- (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.

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

### Question 5

- (a) M/s. PP & Co; a firm of Chartered Accountants, has been auditing the books of accounts of KALI Ltd. for the past 3 years. The company has recently made some major changes in its business policies. While planning to start the audit for the 4th year i.e. for financial year 2024-25, the audit manager of the firm, as per the routine practice, handed over the previous years' audit programme as it is to the audit team with the instructions to adhere unfailingly to the said audit programme. Evaluate the decision of the audit manager with reference to the use of audit programme. **(4 Marks)**
- (b) The management of D. Ltd. have engaged an actuary-expert to ascertain actuarial valuation of gratuity for provision to be made in the accounts. As an auditor of D. Ltd., you plan to use the report of the said expert as audit evidence for ascertaining appropriate valuation of provisions. As an auditor, what will you do to evaluate the competence, capabilities, objectivity and an understanding of the work of the actuary-expert who has carried out actuarial valuation of gratuity? **(4 Marks)**
- (c) Z and Associates are the auditors of Realton Ltd., an export oriented unit, which specializes in manufacturing oil extraction plants. Since many complex processes are involved, they are digitizing their operations. They are restructuring their business models which are driven by technology. Since most of the operations of the company are automated, Z and Associates are planning to do Digital Audit. Explain the use of digital technology in the conduct of an audit. **(3 Marks)**
- (d) Mr. J is an articled clerk with a big Chartered Accountants' firm. He is a part of the engagement team which is conducting the audit of a company for the first time. They are assigned with the work of preparing the draft audit engagement letter. Mr. J is not sure how to go about with this work. Explain what is Audit Engagement Letter and what are its contents? **(3 Marks)**

### Answer:

#### (a) Periodic Review of The Audit Programme

- Periodic review of the audit programme is required to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions.
- If periodic review is not 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. However, as a basic

feature, 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.

**Conclusion:** Decision of audit manager as to use of previous years Audit programme in current year is not proper as major changes in client's business policies are recently made.

**(b) Evaluation of Competence, Capability and Objectivity of Management Expert:**

- To evaluate competence, capabilities and objectivity of a management's expert, auditor need to consider whether that expert's work is subject to technical performance standards or other professional or industry requirements.
- Other matters that may be relevant include:
  - (a) The relevance of the management's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field.
  - (b) The management's expert's competence with respect to relevant accounting requirements.
  - (c) Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

**Obtaining understanding of the work of actuary expert:**

- An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.
- Aspects of the management's expert's field relevant to the auditor's understanding may include:
  - (i) Areas of specialty within field of expertise.
  - (ii) Applicable professional or other standards, and regulatory or legal requirements.
  - (iii) Assumptions and methods used, their general acceptability within that expert's field and appropriateness for financial reporting purposes.
  - (iv) Nature of internal and external data or information the auditor's expert uses.

**(c) Use of Digital Technologies in 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 & other latest technologies to help understand business processes in a better way. By using such tools, auditors can conduct audit 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 shall be recorded in an audit engagement letter or other suitable form of written agreement.

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

- (a) The objective and scope of the audit of the financial statements
- (b) The responsibilities of the auditor
- (c) The responsibilities of management
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

**Question 6**

- (a) You are the auditor of Plus Bank Limited. The bank has made following provisions for the year ended on 31.03.2024:

Particulars	Amount (₹ in crores)
Provision for Bad Debts	66
Provision for Sub-standard Assets	78
Provision for Expenses	24
Provision for Income Tax	55

You are in the process of verifying the provisions and contingencies of the bank. What audit approach and procedures will you adopt to verify the above?

**(4 Marks)**

**OR**

CA Vasu was appointed as the statutory auditor of M/s. Pizza Limited for the financial year 2023-24. While reviewing the internal controls, he observed that the company has entered into many transactions with firms in which the directors are interested. The company's specified procedure was by-passed in such transactions. CA Vasu considered it as a significant deficiency in internal control over related party transactions. He communicated this deficiency to Those Charged With Governance (TCWG) as under,

"Controls over significant transactions with related parties are weak." In view of the above, please explain:

- (i) What is meant by deficiency in internal control?
- (ii) As per SA 265, whether the significant deficiency communicated by CA Vasu to TCWG is appropriate? Explain.

**(4 Marks)**

- (b) CA P is a professional accountant in service. In terms of employment and professional relationships with employer he has to be alert to the possibility of inadvertent disclosure of any information outside the employing organization. However, in view of disclosure required by law, CA P had to divulge the information and documents as evidence in course of legal proceedings. Whether CA P has violated any fundamental principle governing professional ethics in this case? Explain. **(4 Marks)**
- (c) During the audit of accounts for the year ended 31.03.2024, the auditor of FD Limited wanted confirmation from a Trade Receivable, which was outstanding for more than six months, amounting to ₹ 4,25,000/-. The auditor sent a Confirmation letter to the party requesting them to respond directly to him, whether or not they agree with the amount outstanding from them. That trade receivable confirmed to the auditor of FD Limited, that they were required to pay an amount of ₹ 4,20,000 to FD Limited as per their books of accounts. State and explain the type of Confirmation Request sent by the auditor and the course of action that he should take on the confirmation received from the trade receivable. **(3 Marks)**
- (d) P Financial Services Ltd. (PFSL) is a leasing & hire purchase company. You, as an auditor of PFSL, are in the process of examining finance lease agreements executed by them for equipment given on lease. Which points shall be noted by you while examining a particular finance lease agreement entered into by PFSL in respect of a leasing transaction? **(3 Marks)**

**Answer:**

**(a) Audit Procedure for Verification of Provisions and Contingencies:**

- (1) Ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.
- (2) Obtain an understanding as to how the Bank computes provision on standard assets and non-performing assets. It includes the basis of the classification of loans into standard, sub-standard, doubtful and loss assets.
- (3) Obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balance with the general ledger.
- (4) Obtain statement of computation of tax provision 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.
- (5) Other provisions for expenditure should be examined *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**

**(i) Deficiency in Internal Control**

This exists when:

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

(ii) **Communicating Deficiencies in Internal Control:**

- 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 TCWG and management to understand context of communication. Therefore, the above communication is not proper.
- Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company.
- Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

**Conclusion:** Significant deficiency communicated by CA Vasu to TCWG is not appropriate.

(b) **Fundamental Principle governing professional ethics:**

- In the given case, CA P, in view of disclosure required by law, CA P had to divulge the information and documents as evidence in course of legal proceedings. So, fundamental principle of Confidentiality is to be discussed in this situation.
- 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.

**Conclusion:** CA P has not violated any fundamental principle governing professional ethics in this case, as information is being shared due to disclosure requirements of law.

(c) **Type of Confirmation Request:**

Situation as stated in the question is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

**Course of action to be taken on the confirmation received from the trade receivable:**

- In the given case, amount of trade receivable in the books of FD Limited is ₹ 4,25,000. However, confirming party confirmed to the auditor, that they were required to pay an amount of ₹ 4,20,000 to FD Limited as per their books of accounts.
- 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 is known as Exception.



- Auditor is required to:
  - (i) Analyse the reason for difference.
  - (ii) Investigate to determine whether or not they are indicative of misstatements.
  - (iii) Assess the exception to the entire population

**(d) Important points to be examined in the lease agreement:**

- (i) 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) 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 assigning the subletting the equipment and authorises the lessor to do so.

Compiled by: CA. PANKAJ GARG

**Note: Though every care has been taken in preparing the suggested answers; however alternate answers possible based on different understanding/assumption.**

**For academic updates and related contents:**

- Join telegram channel: <https://t.me/altclasses>
- Visit knowledge portal of [www.altclasses.in](http://www.altclasses.in)

**For books/class related queries:**

- E-mail: [altclasses11@gmail.com](mailto:altclasses11@gmail.com)
- Ph.: 9319805511, 7260941195

**For Online purchase of books/classes:** Visit our web portal: [www.altclasses.in](http://www.altclasses.in)