



PAPER – 5: AUDITING AND ETHICS



QUESTIONS

PART – I: Multiple Choice Questions based on Case Scenarios

Case Scenario

Aditya & Co. LLP are the statutory auditors of Benuka Furniture Ltd., a company engaged in the manufacture of wide range of office furniture that suits various workspaces ranging from home offices to corporate environments. The audit team is headed by CA Aditya, being the engagement partner who is further assisted by 2 articled assistants namely Rohit and Mudit. Before starting the audit work of the company, CA Aditya briefed the engagement team about the client's business, the various audit procedures the team can perform and the Standard on Auditing that the team needs to be complied with while conducting the audit of this company. While such discussions were going on, Mudit showed no inclination towards understanding the business and business environment of the company. He was of the view that as a member of the audit team he needs to obtain an understanding about the audit procedures to be performed during the course of audit and not about the client's business.

Rohit was asked by CA Aditya to verify the trade receivables, loan and advances given by the company, amounting to ₹ 20 crore and ₹ 20 lakhs respectively. Rohit asked the concerned official of the company to provide him with the ageing of trade receivables. Rohit decided to send confirmation requests to debtors having balance as on the balance sheet date exceeding ₹ 5 lakhs. He further decided to request to the third party in the request letters to reply positively whether the balance in their books tallies with the balance mentioned in the request letters. Also, while verifying the balance of

loans and advances given by the company, Rohit selected the sample for checking without following any structured approach though he made sure to avoid any conscious biasness or predictability. Thus, he made sure that all the individual balances constituting the total of loans and advances given by the company had a chance of selection.

While checking the balances of fixed assets, Mudit asked the concerned employee of the company to provide him with various documents related to all the fixed assets appearing as on the balance sheet date. He asked for the title deeds with respect to the building owned by the company and the purchase bills for assets purchased by the company. While asking for such documents from the client company, Mudit was of the view that as a member of the audit team he can force the employee of the company to provide him with the required documents.

Further with respect to the inventory of the company, Mudit performed the audit procedures to verify that any inventory balance as at the year end does not include any element of next financial year.

Based on the above facts, answer the following MCQs:

1. Whether the view of Mudit regarding obtaining understanding of the client business is correct:
 - (a) The view of Mudit is correct because as a member of the audit team, he needs an understanding only about the audit procedures to be performed by him.
 - (b) The view of Mudit is not correct because while conducting an audit, the understanding of business and business environment of the client whose audit is to be conducted is very important.
 - (c) The view of Mudit is partially correct because such understanding is required only for the engagement partner and not be the members of the audit team.
 - (d) The view of Mudit is not correct because such information forms a crucial part of the audit report to be issued at the end of the audit process.

2. What kind of confirmation requests Rohit decided to send the debtors for verification of balances of trade receivables?
 - (a) Negative confirmation.
 - (b) Positive confirmation.
 - (c) Exception letter.
 - (d) Written Representation.
3. Which sample selection methods has been opted by Rohit while verifying the loans and advances given by the company?
 - (a) Interval Sampling.
 - (b) Block Sampling.
 - (c) Haphazard Sampling.
 - (d) Monetary Unit Sampling.
4. While verifying the inventory of the client company, which assertion is being verified by Mudit?
 - (a) Cut Off assertion.
 - (b) Valuation assertion.
 - (c) Presentation & Disclosure assertion.
 - (d) Rights & Obligations assertion.
5. With respect to fixed assets, which assertion does Mudit want to check.
 - (a) Valuation assertion.
 - (b) Presentation and Disclosure assertion.
 - (c) Rights and obligations assertion.
 - (d) Existence assertion.

General MCQs

6. CA Rocky is a recently qualified Chartered Accountant. He is appointed as an auditor of Sky Ltd. for the current Financial Year 2023-24. CA Rocky is of the view that he shall record all the matters related to audit i.e., audit procedures to be performed, audit evidence obtained

and conclusions reached. Thus, he maintained a file and recorded each and every finding during the audit. His audit file, also includes audit programmes, notes reflecting preliminary thinking, letters of confirmation, e-mails concerning significant matters, etc. State which of the following need not be included in the audit documentation?

- (a) Audit programmes.
 - (b) E-mails concerning significant matters.
 - (c) Letters of confirmation.
 - (d) Notes reflecting preliminary thinking.
7. CA Ramesh has been the auditor of XYZ Ltd. for the past 10 years. Over these years, he has built a personal relationship with Mr. Rajan, CEO of the company. During the audit, CA Ramesh discovers several discrepancies, but he feels uncomfortable reporting these issues due to his personal relationship with Mr. Rajan. He has also accepted gifts from the company on several occasions. As a result, CA Ramesh is concerned about the impact of his long-standing relationship with Mr. Rajan on the audit report. Which threat to independence exists in the given case?
- (a) Self-interest threat.
 - (b) Familiarity threat.
 - (c) Self-review threat.
 - (d) Advocacy threat.
8. CA Paras is auditing a firm's financial statements and performs detailed procedures to verify assertions. The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms. He checks classification of expenses, ensures trade payables are genuine, compares current and past wages, examines title deeds for land, and check the accuracy of calculation of the conversion of foreign currency into Indian rupees for export invoices. Which audit procedure he performed to verify whether conversion of foreign currency into Indian rupees is proper or not?
- (a) Inspection.
 - (b) Recalculation.

- (c) Observation.
- (d) Reperformance.

PART II – Descriptive Questions**Chapter 1 - Nature, Objective and Scope of Audit**

9. XYZ Ltd., a manufacturing company based in India, operates multiple plants across the country and deals in complex machinery, which requires specialized maintenance and valuation expertise. XYZ Ltd. appointed CA Dhruv as Statutory auditor. During the audit, he observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher reported profits. Does such a matter fall within scope of audit?

Chapter 2 - Audit Strategy, Audit Planning and Audit Programme

10. ATL Pvt. Ltd., a leading manufacturing company, appointed CA Atul as an auditor for the year 2023-24. Given the complexity of the company's operations and the need for a systematic approach, he plans to design a detailed audit programme to ensure the accuracy of financial assertions. As a CA student, if you were assisting CA Atul in constructing this audit programme, what are the points you will keep in mind?

Chapter 3 - Risk Assessment and Internal Control

11. In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. It includes access security as well as program change. What are the objectives and activities included in access security and program change?

Chapter 4 - Audit Evidence

12. Grape Limited presented its financial statements for the F.Y. 2023-24 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons?

Chapter 5 - Audit of Items of Financial Statements

13. CA Tripti is in midst of conducting audit of a company engaged in manufacturing of range of bicycles in an industrial township located in a North Indian state. As part of its activities, the company procures bicycle components from various small and medium sized enterprises. Besides, company imports few bicycle components from China on credit terms. The auditor notices that company has huge trade payables reflected in its financial statements. He wants to be sure that all trade payables reflected in financial statements have been valued appropriately. Suggest few audit procedures to be performed in this respect.

Chapter 6 - Audit Documentation

14. CA Piku has prepared audit documentation of an entity describing nature, timing and extent of audit procedures performed during the course of audit. In documenting nature, time and extent of audit procedures performed, which matters shall be recorded? He is also of the view that such documentation alone as described above meets requirements of Standards on Auditing. Comment upon validity of his views.

Chapter 7 - Completion and Review

15. On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories.

He points it out to the management in a one-liner as under: -

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

Chapter 8 - Audit Report

16. As per SA 701, the objectives of the auditor are to determine key audit matters and having formed an opinion on the financial statements,

communicate those matters by describing them in the auditor's report. Which factors are taken into account by auditor while determining Key Audit Matters? How Key Audit Matters are communicated in audit report?

Chapter 9 - Special Features of Audit of Different Type of Entities

17. A government department has been allocated a budget for infrastructure development. During the audit, the auditor observes the following:
- (i) Some payments were processed without proper approval from the competent authority.
 - (ii) A large-scale project was implemented, but no assessment has been made regarding the expected benefits were achieved or not.
 - (iii) Funds were utilised from an account for which no budgetary provision was made.
 - (iv) Certain expenditures were made without following the prescribed financial regulations.
 - (v) There were instances of unnecessary spending that did not align with financial propriety.

Identify the different types of audits applicable to each of these observations.

Chapter 10 - Audit of Banks

18. While conducting the statutory audit of a large branch of KNB Bank for the year 2023-24, CA Hema observed that Profit and Loss account of branch reflects interest income of ₹ 80 crores and other income of ₹ 5 crores. She also noticed that few borrower accounts at branch have slipped into NPA category in past periods as well as in current year. Which audit procedures should be performed by her to verify reversal of income in the books of branch?
19. CBC Bank Ltd. has multiple loan accounts classified as Non-Performing Assets (NPAs). During the financial year, some borrowers made partial payments towards their outstanding dues. However, there was no explicit agreement between the bank and the borrowers regarding the

appropriation of these recoveries i.e., whether they should be adjusted against principal or interest.

The bank's finance team decided to recognise the recovered amount as interest income in its financial statements. However, during the statutory audit, the auditors raised concerns about the treatment of these recoveries.

Discuss the appropriate accounting treatment of partial recoveries in NPAs. Also, explain the principles that banks should follow in recognising interest income from NPAs.

Chapter 11 - Ethics and Terms of Audit Engagements

20. CA Puneet is appointed as an auditor of Kamla Limited for the F.Y. 2023-24. The management of Kamla Limited has requested the auditor to change the terms of original engagement as the company has diversified its business and a few new products have been introduced by the company. Whether CA Puneet can agree to the request made by the management? Under which circumstances can the client make a request to the auditor for a change in the terms of engagement?



SUGGESTED ANSWERS

PART – I: Answers to Multiple Choice Questions

MCQ No.	Answer
1.	(b)
2.	(b)
3.	(c)
4.	(a)
5.	(c)
6.	(d)
7.	(b)
8.	(b)

PART – II: Answers to Descriptive Questions

9. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The scope of audit of financial statements includes coverage of all aspects of entity, reliability and sufficiency of financial information and proper disclosure of financial information.

In the given situation, CA. Dhruv observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher profits. Since proper disclosure of financial information is covered under the scope of audit, thus, the auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Thus, it can be concluded that proper disclosure of financial information is well within scope of audit.

10. For the purpose of programme construction, the following points should be kept in mind:
- (i) Stay within the scope and limitation of the assignment.
 - (ii) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

- (iii) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (iv) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- (v) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
- (vi) Consider all possibilities of error.
- (vii) Co-ordinate the procedures to be applied to related items.

11. Access Security in Automated Environment:

The objective of Access Security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

- (i) Security Organization & Management
- (ii) Security Policies & Procedures
- (iii) Application Security
- (iv) Data Security
- (v) Operating System Security
- (vi) Network Security
- (vii) Physical Security

Program Change in Automated Environment:

The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives.

It includes activities such as change in management process, recording, managing and tracking change requests, making and testing changes etc.

- 12. Purpose of Applying Analytical Procedure:** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Grape Ltd. would achieve the following by carrying out the comparison stated in the question:

- (i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
 - (ii) By setting up certain expenses' ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
 - (iii) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.
 - (iv) It may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.
- 13.** Audit procedures to be performed to verify that all trade payables reflected in financial statements have been valued appropriately are:
- Review the process followed by the Company to identify if any old creditor balance needs to be written back. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
 - Obtain the ageing of payable balances, and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.

- Check that write backs in the trade payable balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example, CEO/MD.
 - Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11.
 - Understand management's process to identify the principal amount and the interest due thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.
- 14.** In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
- (a) The identifying characteristics of the specific items or matters tested.
 - (b) Who performed the audit work and the date such work was completed; and
 - (c) Who reviewed the audit work performed and the date and extent of such review.

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- (a) The nature, timing and extent of the audit procedures performed.
- (b) The results of the audit procedures performed, and the audit evidence obtained; and
- (c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

Thus, all above matters shall be recorded to meet requirements of SA 230. Documenting nature, time and extent of audit procedures performed alone does not meet the requirements of SA 230. Therefore, CA Piku's views are not valid.

- 15.** As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", while pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

In the given situation, auditor noticed significant deficiency in internal control over inventories and he pointed out the same to management i.e. "Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

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 the importance of such a control, it should be stated that responsibility be fixed for concerned person(s) for adhering to such an important control.

- 16.** The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:
- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
 - Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
 - The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined, as stated above, were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and
 - (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.
- 17.** The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred.
- (i) When payments are processed without proper approval from the competent authority, an Audit of Sanctions is required. This ensures that there is sanction, either special or general, accorded by competent authority authorising the expenditure.
 - (ii) In cases where a large-scale project has been implemented without any assessment of whether the expected benefits were achieved, a Performance Audit is necessary. This type of audit ensures that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them.
 - (iii) When funds were utilised from an account for which no budgetary provision was made, an Audit Against Provision of Funds is conducted. This ensures that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority.

- (iv) If expenditures are made without adhering to the prescribed financial regulations, an Audit Against Rules and Orders is applicable. This audit ensures that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority.
- (v) Instances of unnecessary spending that do not align with financial propriety fall under the scope of a Propriety Audit. It ensures that the expenditure is incurred with due regard to broad and general principles of financial propriety.

18. The following audit procedures should be performed to verify reversal of income in books of branch:

- If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
- In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
- Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).
- Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

19. Appropriate accounting treatment of partial recoveries in NPAs:

In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards

principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.

The appropriate policy to be followed is to recognise income as per AS 9, "Revenue Recognition", when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.

Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

20. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, a significant change in nature or size of the entity's business is one of the factors which may make it appropriate to revise the terms of the audit engagement.

In the given situation, Kamla Limited has diversified its business, and few new products have also been introduced by the company which is indicative of significant change in nature or size of the entity's business. In view of the above, CA. Puneet can agree to the request made by the management to change the terms of the audit engagement. Therefore, the request of Management to change the terms of audit engagement is appropriate.

A request from the client for the auditor to change the engagement may result from:

1. a change in circumstances affecting the need for the service.
2. a misunderstanding as to the nature of an audit or related service originally requested.
3. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.