**Mock Test Paper - Series I: July, 2024**

**Date of Paper: $2^{nd}$ August, 2024**

**Time of Paper: 2 P.M. to 5 P.M.**

## INTERMEDIATE GROUP – II

## PAPER – 5: AUDITING AND ETHICS

**Time Allowed – 3 Hours** **Maximum Marks – 100**

**PART I - Case Scenario based MCQs (30 Marks)**

***Write the most appropriate answer to each of the following multiple-choice questions by choosing one of the four options given. All MCQs are compulsory and carries 2 Marks each.***

### Case Scenario 1

M/s Vishwacharya and Associates, a CA firm based in Orissa, is appointed as an auditor of CBF Bank for the financial year 2023-24. During the course of audit, it came to notice that CBF Bank has sanctioned an overdraft facility of ₹ 75 lakh to Times Ltd. However, as per the stock statement furnished for the last quarter, the drawing power was calculated to be ₹ 50 lakh. It was observed that few advances were guaranteed by the:

(i) Central Government as part of 'Make in India' initiative. However, the guarantee was not invoked, and the advances were overdue by 75 days. These advances were classified as standard assets and were regarded as NPA for income recognition purpose.

(ii) State Government as part of power generation initiative. However, the guarantee was not invoked, and the advances were overdue by 80 days. These advances were also classified as standard assets and were regarded as NPA for income recognition purpose.

Additionally, XYZ Ltd., is a borrower availing cash credit facility of ₹ 110 Lakh against security of paid stocks and debtors up to 90 days. Margin stipulated was 25% of stock as and 40% for debtors. Bank has calculated drawing power based on following information provided by XYZ Ltd.

| Particulars | Amount (₹) |
|---|---|
| Value of Stocks (as on 31.12.2023) | 130 Lakh |
| Value of Debtors (as on 31.12.2023) | 75 Lakh |
| Value of stocks (Fully damaged and included in (i) above) | 7 Lakh |
| Value of Debtors (exceeding 90 days included in (ii) above) | 10 Lakh |
| Value of creditors for goods | 60 Lakh |

Also, the outstanding balance in one of the Loan accounts was ₹ 25 Lakh and the realisable value of the security as assessed by the bank / approved valuers was ₹ 2.25 Lakh. Bank identified the same as erosion in the value of security. It was classified as doubtful category and provision was made for the doubtful assets. A discussion also took place among the team members regarding issuance of the audit reports after completion of the bank audit and annexure to the same such as Long Form Audit Report, Report on compliance with SLR Requirements, Report on Treasury Operations – as per RBI guidelines, Report on compliance as per Ghosh committee recommendations and Report on adverse credit - lending ratio in the rural areas, etc.

Based on the above facts, answer the following: -

1. With respect to the overdraft facility sanctioned to Times Ltd., the account would be termed as out of order if:

   (i) The outstanding balance remains continuously in excess of ₹ 75 Lakh.

   (ii) The outstanding balance remains continuously in excess of ₹ 50 Lakh.

   (iii) The outstanding balance in the account is less than ₹ 75 Lakh but there are no credits or payments deposited into the account continuously for 90 days as on balance sheet date

   (iv) The outstanding balance is less than ₹ 50 Lakh.

   Choose the correct option from below:

   (a) (i), (ii) and (iii)

   (b) (i), (iii) and (iv)

   (c) (ii),(iii) and (iv)

   (d) (iii) and (iv)

2. Which of the treatment by the bank on the provisioning and income recognition is correct in case of bank guarantee given by the Central Government and State Government?

   (a) Both (i) and (ii) are correct

   (b) Only (ii) is correct

   (c) Only (i) is correct

   (d) Both (i) and (ii) are incorrect.

3. In the given case drawing power of the borrower XYZ Limited should be:

   (a) ₹ 86.25 Lakh

   (b) ₹ 76.35 Lakh

   (c) ₹ 96.25 Lakh

   (d) ₹ 85.45 Lakh

4. The Bank has identified an erosion in the value of security and made provision for doubtful assets. Whether the treatment by bank for the doubtful asset is correct?

   (a) Yes. The security should be classified under doubtful category. It may be either written off or fully provided by the bank.

(b) No. The existence of such security should be ignored, and the asset should straight away be classified as loss asset. It may be either written off or fully provided by the bank.

(c) Yes. The security should be classified under doubtful category and provisioning should be made as applicable for doubtful assets.

(d) No. The existence of the security should be ignored, and the asset should straight away be classified as loss asset. Provisioning should be made for doubtful assets.

5. The Statutory Central Auditors of a bank must furnish, in addition to the main audit report, various other audit reports. From the options, choose the audit reports that M/s Vishwacharya and Associates shall furnish.

(i) Long Form Audit Report

(ii) Report on compliance with SLR Requirements

(iii) Report on Treasury Operations – as per RBI guidelines

(iv) Report on compliance as per Ghosh committee recommendations

(v) Report on adverse credit - lending ratio in the rural areas.

Choose the correct answer:

(a) (i), (ii),(iii),(iv) and(v)

(b) Only (i),(ii),(iii) and (iv)

(c) Only (i),(ii) and (iii)

(d) Only (i),(ii) and (v)

**Case Scenario 2**

Priority Limited is a large company engaged in manufacturing of terry towels making steady profits on a year-to-year basis. PMR & Associates, statutory auditors of the company since last two years, are in process of establishing audit strategy for conducting statutory audit under Companies Act, 2013 for year 2023-24.

The company has 5 branches which are audited by independent auditors appointed under Companies Act, 2013. It also has a wholly owned subsidiary company which is audited by another audit firm under name of JKL & Associates. The engagement team has noticed that company has maintained several bank accounts and there is substantial movement in fixed deposits during the year leading to risk of misstatement in cash and cash equivalents. The engagement team has planned procedures regarding the same.

(i) At planning stage, engagement partner is also trying to set materiality for financial statements as a whole. The following information extracted from financial statements is given as under: -

| **Particulars** | **(Amount in ₹ crores)** |
|---|---|
| Revenue | 100 |
| Total Assets | 40 |

| | |
|---|---|
| Profit before Tax | 8 |
| Total Liabilities (excluding Equity) | 30 |

(ii) While designing a sample for verifying revenues of company as part of tests of details, engagement partner has determined "tolerable misstatement" for ₹ 5.00 Lakh in order to address the risk that aggregate of individual immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. One of the newly joined engagement team members has little conceptual understanding of "tolerable misstatement" determined by engagement partner. He also has no idea of the effect of change in tolerable misstatement on sample size.

(iii) During course of audit, while performing tests of details, engagement team has come across certain misstatements in selected sample pertaining to verification of revenues. The team has projected misstatements to population of revenues. The team wants to comply with the Standards on Auditing strictly.

Based on the above facts, answer the following: -

6. The auditors of company are in process of establishing audit strategy. Which of the following is not a relevant factor in establishing overall audit strategy in the given case scenario?

   (a) Consideration of 5 branches which are audited by independent auditors

   (b) Consideration of wholly owned subsidiary company audited by another audit firm

   (c) Expected time of holding AGM in accordance with provisions of Companies Act, 2013

   (d) Nature, timing and extent of planned procedures for cash and cash equivalents

7. For Priority limited, which benchmark would the engagement partner most likely to use for setting materiality for the financial statements as a whole?

   (a) A percentage of Revenue

   (b) A percentage of Total assets

   (c) A percentage of Profit before tax

   (d) A percentage of Total liabilities (excluding equity)

8. In the given case scenario, assume that the engagement partner has decided to increase tolerable misstatement to ₹ 10.00 Lakh while designing sample described. Select the correct statement.

   (a) It would lead to decrease in sample size.

   (b) It would lead to an increase in sample size.

   (c) It would have no effect on sample size.

   (d) It is not possible to draw inference on sample size due to increase in tolerable misstatement.

9. While performing procedures on designed sample, the engagement team identified certain misstatements in selected sample and projected these to the entire population of revenues. According to the requirements of the Standards on Auditing, which statement is correct in this regard?

   (a) Anomalous misstatement is auditor's best estimate of misstatement in population.

   (b) The projected misstatement plus anomalous misstatement, if any, is best estimate of misstatement in population.

   (c) When projected misstatement exceeds tolerable misstatement, sample provides a reasonable basis for conclusion about tested population.

   (d) When projected misstatement plus anomalous statement, if any, exceeds tolerable misstatement, sample provides a reasonable basis for conclusion about tested population.

**Case Scenario 3**

Bandhu Charitable Trust is considering appointment of MNO & Associates, Chartered Accountants, as independent auditors of its financial statements. The Trust is engaged in providing affordable healthcare services. It is in interest of both auditor and client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent. It is, therefore, important that each party should be clear about nature of engagement. It should exactly specify the scope of work. Such an "engagement letter" is exchanged between Trust management and auditors.

While performing audit procedures, it is noticed by auditors that bills of two vehicles are not in name of Trust but in name of trustees. However, payment of these vehicles was made from bank account of Trust. The said vehicles are used for activities of Trust.

It is also noticed that a sum of ₹ 50.00 Lakh is reflected in Trust's financial statements in name of Gamma Instrument and Equipment in schedule of creditors. The said amount is outstanding since two years. The auditors sent confirmation request to the said supplier and seek management's co-operation in this regard. However, management of the Trust informs the auditor regarding certain dispute going on with the supplier of equipment due to some quality issues. It is further informed that dispute is near settlement and it would not be proper to send confirmation request as it can affect negotiation process.

Based on the above facts, answer the following: -

10. As regards exchange of engagement letter between Trust management and auditors is concerned, which of following statements is likely to be true?

   (a) Engagement letter is sent by MNO & Associates to Bandhu Charitable Trust. It includes reference to the expected form and content of report to be issued by them and a statement that there may be circumstances in which such report may differ from its expected form and content.

   (b) Engagement letter is sent by Bandhu Charitable Trust to MNO & Associates. It includes reference to the expected form and content of report to be issued by auditors. However, it does not include a statement that such report may differ from its expected form and content.

(c) Engagement letter is sent by MNO & Associates to Bandhu Charitable Trust. It includes reference to expected form and content of report to be issued by them. However, it does not include a statement that such a report may differ from its expected form and content.

(d) Engagement letter is sent by MNO & Associates to Bandhu Charitable Trust. It does not include reference to the expected form and content of report to be issued by them.

11. Considering the issues related to vehicles as described in the case study, identify the most appropriate statement.

(a) Auditors have identified misstatement concerning "Existence" assertion made by Trust management.

(b) Auditors have identified misstatement concerning "Rights and Obligations" assertion made by Trust management.

(c) Auditors have identified misstatement concerning "Accuracy" assertion made by Trust management.

(d) Auditors have identified misstatement concerning "Completeness" assertion made by Trust management.

12. What course of action should the auditor take regarding the amount payable to the equipment supplier when management has communicated that sending a confirmation request could negatively impact the negotiation process?

(a) The auditor should issue adverse opinion in auditor's report.

(b) The auditor should seek audit evidence as to the validity and reasonableness of the reasons for refusal and perform alternative audit procedures.

(c) The auditor should withdraw from engagement as Trust management's refusal is a limitation on scope of independent audit.

(d) The auditor should disclaim opinion in auditor's report.

**MCQs**

13. CA Prince, after developing the audit strategy for Vedika Limited, develops an audit plan but finds a need to revise the materiality levels set earlier and therefore, a deviation from the already set audit strategy is felt necessary. In this case, he should

(a) Drop the audit and withdraw from the engagement.

(b) Devise a new audit plan and then, change the strategy as per the Revised Plan.

(c) First Modify the audit strategy and thereafter, prepare the audit plan according to the modified strategy.

(d) Continue with the Audit Plan without considering the Audit Strategy.

14. Jasmine was of the view that audited financial statements are not a guarantee against probable wrong doings in the financial matters of companies. What kind of assurance does audit of financial statements provide?

    (a) It provides reasonable assurance meaning a low level of assurance.

    (b) It provides reasonable assurance meaning a high level of assurance.

    (c) It provides reasonable assurance meaning an absolute level of assurance.

    (d) It provides reasonable assurance meaning a moderate level of assurance.

15. CA Raman instructed his article Raju to verify whether employee benefit expense of Prep Limited has been fairly allocated between the operating expense incurred in production activities and general expense. Which of the following assertions is being addressed by this instruction?

    (a) Completeness

    (b) Presentation and Disclosure

    (c) Measurement

    (d) Occurrence

**PART II - Descriptive Questions**

*Question No. **1** is compulsory.*

*Attempt any **four** questions from the Rest.*

1. (a) Subodh has recently joined an audit firm as an articled clerk. He was in process of assembling audit working papers in audit file of Cop Limited, as per the instructions of his senior. While assembling, he noticed following working paper in audit file: -

**Timing of Audit Activities**

| **Activitiy** | **Expected Timing** |
|---|---|
| Audit Planning | July 1, 2023 - July 5, 2023 |
| Review by EQCR | July 6, 2023 - July 7, 2023 |
| Audit Field Work | July 10, 2023 - August 20, 2023 |
| Review by Manager | August 21, 2023 |
| Review by Engagement Partner | August 22, 2023 - August 25, 2023 |
| Review by EQCR | August 26, 2023 - August 27, 2023 |
| Response on Audit Memo | August 28, 2023 |
| Review by Partners – internally post response on audit memo | August 29, 2023 |
| Review by EQCR | August 30, 2023 |

| | |
|---|---|
| Finalization of Audit Report and Financial Statements | September 01, 2023 - September 02, 2023 |
| Issuance of Audit Report and Financial Statements | September 03, 2023 |

The above working paper lists certain factors which are considered by the auditor while establishing audit strategy. Explain how these considerations highlighted in above working paper could have helped the auditor? **(5 Marks)**

(b) CA Tina, while inspecting financial statements of a company, notices that gross profit ratio of company has increased from 14% in year 2022-23 to 24% in year 2023-24. Considering the above, she has assessed the risk of material misstatement to be high with respect to assertions relating to revenue and various direct expenses. CA Tina wants to know few possible reasons which could have led to abnormal jump in gross profit ratio.

During the discussion among engagement team members, her junior Ms. Tisha, expressed her view that detection risk in this engagement should be kept at high level.

(i) List out a few possible reasons which could have led to abnormal jump in gross profit ratio.

(ii) Do you agree with viewpoint of Tisha? Provide reasons for your answer. **(5 Marks)**

(c) Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor? **(4 Marks)**

2. (a) Stay fit Private Limited is a start-up that has been in business for about two years. It runs an application which provides valuable information pertaining to nutrition and helps its clients to access customized healthy food. The company's revenues are expected to grow in the coming period. Although company has reflected net losses in its financial statements for the last two years, it has managed to meet its financial commitments. The financial statements for last two years were prepared on going concern basis of accounting. The management of company wants to follow the same basis of accounting for the current year. Is the view of management appropriate? How does the "going concern" affect the preparation of financial statements? **(5 Marks)**

(b) PQR & Associates and MNO & Co., both firms of Chartered Accountants, have been appointed as joint auditors of Gama and Beta Limited. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard with reference to the Standards on Auditing. **(5 Marks)**

(c) The management of Cool Drinks Limited suspects that some employees of the company may be involved in making fraudulent payments to dummy workers at its various plants in the country. Therefore, they are considering appointment of a firm of auditors to conduct audit involving detailed examination of accounts. However, one senior person among Board members, Mr. P, objects to use of word "audit" in proposed assignment. Comment. Also, discuss how audit is different from investigation. **(4 Marks)**

3. (a) Mr. Chetan is appointed as an auditor of Spot Limited, a small company. Mr. Chetan is aware that CARO 2020 is not applicable to small company. List out the classes of companies that are specifically exempt from the applicability of CARO 2020. **(5 Marks)**

(b) Zed Limited is engaged in the manufacturing and export of shoes. The statutory auditor of the company wants to reasonably ensure that only the inventories recorded in the financial statements are exclusively owned by the company and do not include any inventories that belong to third parties but includes inventories owned by the company but lying with third party. Advise the auditor on the audit procedures to be performed to achieve this assurance. **(5 Marks)**

(c) SQC 1 requires assumption of leadership responsibilities for quality within firm. Are such leadership responsibilities required for audit engagements only? Who assumes such leadership responsibilities within firm? How it is important for audit quality? **(4 Marks)**

4. (a) CA X is contemplating the use of negative confirmation requests as the sole substantive audit procedure to verify certain accounts payable balances reflected in financial statements of a company. Which conditions need to be met to use negative confirmation requests as stated above? Additionally, CA X is of the view that negative confirmations provide same level of persuasive audit evidence as in case of positive confirmations. Do you agree with his viewpoint? Provide reasons for your answer. **(5 Marks)**

(b) CA H has been offered audit of financial statements of a society engaged in promoting social causes, such as setting up of drug de-addiction centres for misguided youth and rehabilitating such young people by helping them find avenues of gainful employment. However, CA H failed to send audit engagement letter to the society's governing body and proceeded to conduct the audit. In the absence of this letter, the governing body is of the view that purpose of such an audit is to provide absolute assurance against probable errors and frauds in the financial statements. Does it constitute violation of fundamental principles governing professional ethics? State reasons for the same. **(5 Marks)**

(c) While verifying cash and cash equivalents of a company, CA D engagement partner, is very particular that Bank reconciliation statement (BRS) prepared by the management in respect of bank account maintained by the company is proper to rule out misstatements in cash and cash equivalents reflected in the financial statements of the company. The company does not use net banking and prefers to issue cheques to its creditors and receives substantial payments locally through account payee cheques. Which aspects need to be taken care of and verified by CA D in respect of BRS? **(4 Marks)**

5. (a) CA Sumit has been appointed as statutory auditor of Core Limited. List out some matters that he may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency". **(5 Marks)**

(b) While conducting the audit of Zeena Limited, CA E is trying to obtain understanding of different components of internal controls of the company. Such an understanding is necessary and is required to be documented in accordance with Standards on Auditing. In this context, how he shall obtain understanding of the risk assessment process of the company and how is this understanding important for the auditor?

**(5 Marks)**

(c) Section 72(1) of the Multi-State Co-operative Societies Act, 2002 states that only a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can be appointed as an auditor of a multi-state co-operative society. Who, according to Section 72(2), is disqualified from being appointed as auditors of a multi-state co-operative society? **(4 Marks)**

6. (a) National Bank has advanced cash credit facility of ₹ 25 Lakh to Sun Industries. Following is the extract of account of Sun Industries reflecting in CBS of Bank from December 1, 2023 to March 31, 2024: -

| Date | Particulars | Dr. | Cr. | Balance (Dr.) |
|---|---|---|---|---|
| 01/12/2023 | To Transfer | 45,000 | | 24,75,000 |
| 31/12/2023 | By Clearing | | 1,00,000 | 23,75,000 |
| 31/12/2023 | To Interest | 25,000 | | 24,00,000 |
| 31/01/2024 | To Interest | 24,700 | | 24,24,700 |
| 29/02/2024 | To Interest | 24,800 | | 24,49,500 |
| 31/03/2024 | To Inspection charges | 1,000 | | 24,50,500 |
| 31/03/2024 | To Interest | 24,900 | | 24,75,400 |

Drawing power during the above period was consistent at ₹ 25 Lakh. The account was classified as "Standard asset" as on 31.12.2023 in books of Bank. The security charged with the bank remains intact throughout this period.

Comment on "asset classification" of above account as on 31st March 2024 in books of Bank in accordance with RBI norms. **(5 Marks)**

(b) While performing audit of financial statements of a listed company, statutory auditor needs to maintain an attitude of professional skepticism for related party information. State examples of the records or the documents that may provide information about related party relationships and transactions. **(5 Marks)**

(c) Sanjana is of the view that there exist some disadvantages in the use of audit programmes but most of these can be removed by following some concrete steps. Do you agree with her perspective? Comment. **(4 Marks)**

**OR**

BOTS is a manufacturing entity having material Property, Plant and Equipment (PPE) items in its financial statements. The auditor of the entity wants to verify that PPE items have been valued appropriately as per generally accepted accounting policies and practices. Comment on significance of such verification. Suggest a few audit procedures in this regard. **(4 Marks)**

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**INTERMEDIATE: GROUP – II**

**PAPER – 5: AUDITING AND ETHICS**

**SUGGESTED ANSWERS / HINTS**

**Part I -Multiple Choice Questions**

**1. (a)**

**2. (c)**

**3. (a)**

**4. (b)**

**5. (b)**

**6. (d)**

**7. (c)**

**8. (a)**

**9. (b)**

**10. (a)**

**11. (b)**

**12. (b)**

**13. (c)**

**14. (b)**

**15. (b)**

**Part II -Descriptive Answers**

**1. (a)** 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. One of the factors to be taken into consideration while establishing audit strategy relates to ascertaining of reporting objectives of engagement to plan the timing of the audit and the nature of the communications required. Some of the instances are given under:

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report

- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

In the given case, working paper highlights that auditor has taken into account expected timelines to plan the audit and nature of the communications required. Since the working paper relates to the statutory audit of a company, the ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications.

**(b)** **(i)** In the given case, risk of material misstatement has been assessed as high in respect of assertions relating to revenue and various direct expenses due to increase in gross profit ratio of company from 14% in year 2022-23 to 24% in year 2023-24.

Few possible reasons which could have led to abnormal jump in gross profit ratio include: -

- Overvaluation of inventories
- Overstatement of revenues
- Understatement of direct expenses

**(ii)** SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Tisha is of a view that detection risk in this engagement should be kept at high level whereas in the given situation, risk of material misstatement has been assessed as high for assertions relating to revenue and direct expenses. Therefore, detection risk has to be kept at low level so that a material misstatement in these assertions does not remain undetected.

Therefore, view of Ms. Tisha is not proper.

**(c)** As per SA 500, "Audit Evidence", if the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements. When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: -

(a) Evaluate the competence, capabilities and objectivity of that expert

(b) Obtain an understanding of the work of that expert and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Before using the work of PQR Associates, management's expert, auditor should ensure that the criteria mentioned above are fulfilled.

**2. (a)** As per SA 570, "Going Concern", going concern is one of the fundamental accounting assumptions. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

In the given situation, company has reflected net losses in financial statements of last two years but is able to meet its financial commitments signifying its ability to carry on business/trade. The revenue of company is also expected to grow in the coming period. It shows that management has neither the intention nor the necessity of liquidation or of curtailing materially the scale of operations. Therefore, view of the management for following going concern basis of accounting in current year is appropriate.

Further, the significance of going concern is due to its effect on the preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

**(b)** In accordance with SA 299, "Joint Audit of financial statements", before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, PQR & Associates and MNO & Co., the joint auditors should:

(a) identify division of audit areas and common audit areas;

(b) ascertain the reporting objectives of the engagement;

(c) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;

(d) consider the results of preliminary engagement activities, or similar engagements performed earlier

(e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

**(c)** Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation. The objective of audit, on the other hand, 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.

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

In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of "investigation".

Therefore, Mr. P is right in objecting the use of word "audit" in the proposed assignment.

**3. (a)** CARO 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except–

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;

(ii) an insurance company as defined under the Insurance Act,1938;

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and

(v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

**(b)** Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under: -

- Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
  - Compute inventory turnover ratio (COGS/ average inventory)
  - Perform vertical analysis (inventory/ total assets)
  - Compare budgetary expectations vis-à-vis actuals
- Examine non-financial information related to inventory, such as weights and other measurements.
- Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- Verify the clerical and arithmetical accuracy of inventory listings.
- Reconcile physical inventory amounts with perpetual records.
- Reconcile physical counts with ledger control totals.
- Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
- Goods received on a consignment basis have been properly segregated from other items of inventory.

**(c)** SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Therefore, such leadership responsibilities are required for all engagements and not for audit engagements only.

Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

**4. (a)** In accordance with SA 505, "External Confirmations", the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

(i) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.

(ii) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions.

(iii) A very low exception rate is expected and

(iv) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

Therefore, view of CA X is not correct.

**(b)** As per SA 210, "Agreeing the Terms of Audit Engagements", 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. Such a letter includes, inter alia, objective and scope of audit of financial statements. The absence of such a letter leads to misunderstanding between auditor and management. As auditor has failed to send engagement letter, the governing body has formed an improper view of objective and scope of audit of financial statements.

By not following requirements of SA 210, CA H is not acting ethically. He has violated principle of professional competence and due care governing professional ethics. This principle 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. Maintaining professional competence requires awareness of current technical and professional standards. Non sending of engagement letter shows lack of such awareness on part of CA H. Therefore, he has violated said fundamental principle governing professional ethics.

**(c)** CA D should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

Verification of BRS shall entail the following: -

- Tallying the balance as per bank book to the bank confirmation/ statement.

- Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.
- Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.
- Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

**5. (a) Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency**

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process, for example:
  - — General monitoring controls (such as oversight of management).
  - — Controls over the prevention and detection of fraud.
  - — Controls over the selection and application of significant accounting policies.

— Controls over significant transactions with related parties.

— Controls over significant transactions outside the entity's normal course of business.

— Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

**(b)** CA E, the auditor of Zeena Limited, shall obtain an understanding of whether the entity has a process for: -

(a) Identifying business risks relevant to financial reporting objectives

(b) Estimating the significance of the risks

(c) Assessing the likelihood of their occurrence

(d) Deciding about actions to address those risks

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

**(c)** As per section 72 of the Multi-State Co-operative Society Act, 2002 following persons are not qualified for appointment as auditors of a multi-state co-operative society: -

(a) A body corporate

(b) An officer or employee of the multi-state co-operative society

(c) A person who is a member or who is in employment, of an officer or employee of the multi-state co-operative society.

(d) A person who is indebted to the multi-state co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the multi-state co-operative society for an amount exceeding one thousand rupees.

**6. (a)** In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains "out of order" in respect of an Overdraft/Cash Credit.

An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or

- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of ₹ 25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet. Therefore, it has become out of order and is required to be classified as NPA.

Under non-performing assets, it would be classified as "Sub-Standard Asset" as it has remained NPA for a period of less than or equal to 12 months.

**(b)** During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. Examples of the records or the documents that may provide information about related party relationships and transactions are:

1. Entity income tax returns.
2 Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditor's reports.
12. Documents associated with the entity's filings with a securities regulator (e.g. prospectuses).

**(c)** The view of Sanjana is appropriate. Some disadvantages are there in the use of audit programmes but most of these can be removed by following some concrete steps. The disadvantages are: -

(i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(iii) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(iv) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

**OR**

It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Therefore, such verification is significant.

Audit procedures that the auditor should follow to verify that the PPE items have been valued appropriately as per generally accepted accounting policies and practices are: -

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 Impairment of Assets.