**Mock Test Paper - Series II: December, 2024**

**Date of Paper: 13th December 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**

Oval Services Ltd. appointed Rupa & Associates as the auditors for the financial year 2023-2024. The auditors believe that an audit program is crucial in providing clear and comprehensive instructions for the tasks to be carried out, offering a total perspective of the work involved. This is particularly important for large audits, and as such, they prepared an initial audit program based on the company's organisational structure and effective internal controls. During the audit, CA Nitin, Engagement Partner identified issues with the company's debt management practices, prompting the inclusion of a more detailed review of the loan agreements. However, in his opinion the planned review of petty cash was unnecessary due to the company's policy of limiting cash transactions. Thus, review procedure was removed from the audit programme.

To verify the balances of trade payables, the auditor decided to send external confirmation requests to the creditors of the company. These requests were made to verify the balances as on 20th March 2024, a date chosen deliberately to ensure the accuracy and completeness of the liabilities, free from any influence or prior knowledge of management. This approach was taken to maintain the integrity of the confirmation process. However, it was noted that M/s. Keshav Traders and M/s. Amrit Distributors did not respond to the confirmation requests.

Furthermore, the auditor noted that in the financial year 2023-2024, the company's Property, Plant, and Equipment (PPE) was revalued, resulting in an increase of 5% in the net carrying value of its machinery from ₹10 lakh to ₹10.5 lakh.

Also, due to the significant compliance burden, company is considering to convert into a Limited Liability Partnership (LLP). Management views the LLP structure as a hybrid business model that combines the advantages of both companies and partnerships. Additionally, they believe this conversion would relieve them of mandatory audit requirements.

**Based on the above facts, answer the following: -**

1. Whether audit team is correct in excluding the planned review of petty cash from the audit programme?

   (a) No. Because an audit programme should always include a petty cash review, regardless of company policy.

   (b) Yes. Because the company's internal controls and policy of limiting cash transactions reduce the need for a petty cash review in the audit programme.

   (c) No. Because the audit programme must cover all the areas of financial transactions, including petty cash, to ensure comprehensive auditing.

   (d) Yes. Because the audit programme should only focus on areas with high financial risk, and petty cash is not a high-risk area.

2. Whether the decision of auditor to send the confirmation request to the creditors of the company as on 20th March 2024 justified?

   (a) Yes, decision of the auditor is correct as the auditor is allowed to choose any date reasonably close to the balance sheet date for confirmation, and the selected date helps to ensure the accuracy of the liabilities without consultation from the management.

   (b) No, decision of the auditor is not correct as the auditor should have sent the confirmation requests for the balance sheet date as this would accurately reflect the liabilities as on that date.

   (c) Yes, decision of the auditor is correct as the auditor is allowed to choose any date which is reasonably close to the balance sheet date for confirmation, and the selected date should be decided in consultation with the management.

   (d) No, decision of the auditor is not correct as confirmation should be asked within a week of the date of audit report.

3. Which of the following is not an appropriate procedure to verify the balances for M/s. Keshav Traders and M/s. Amrit Distributers?

   (a) Breaking down the balance into individual transactions and making sure they actually happened.

   (b) Checking payments made after the year-end to vendors who didn't respond to confirmation requests.

   (c) Comparing the balance to the original invoices from the vendors.

(d) Request a written representation from management confirming that all payables are accurately recorded and complete.

4. In the given case, is there any requirement for separate disclosure of the PPE revaluation?

   (a) Yes, separate disclosure is required due to the 5% increase in carrying value.

   (b) No, separate disclosure is not required as the change in carrying value is less than 10%.

   (c) Yes, separate disclosure is required regardless of the percentage change.

   (d) No, separate disclosure is not required unless the revaluation results in a material change in the carrying value.

5. What is your perspective on the management's view regarding the audit requirements for an LLP?

   (a) An LLP is always required to conduct an audit, regardless of its turnover or capital contribution.

   (b) An LLP is always required to conduct an audit if either the turnover exceeds ₹40 lakhs or the capital contribution exceeds ₹25 lakhs.

   (c) An LLP is always required to conduct an audit if either the turnover exceeds ₹25 lakhs or the capital contribution exceeds ₹40 lakhs.

   (d) An LLP is always required to conduct an audit if the capital contribution exceeds ₹25 lakhs and the turnover exceeds ₹40 lakhs.

**Case Scenario 2**

Shreyansh, a Chartered Accountancy student, is part of an engagement team conducting audit of the Coimbatore branch of XYZ Bank under the guidance of CA Dilip, the Engagement Partner. Shreyansh has been assigned the task of verifying provisions made for the branch's non-performing assets (NPAs) and classification of certain loans as on March 31, 2024, of which details are as under:

**Non-Performing Assets (NPAs):**

| Name of Account | NPA classification | Outstanding amount as on March 31st, 2024 (In ₹ lakhs) | Amount of provision made (In ₹ lakhs) | Security Available |
|---|---|---|---|---|
| AB Industries | Doubtful (D1) | 10.00 | 5.00 | Fully secured |
| Mars Traders | Substandard asset | 50.00 | 7.50 | Fully secured |
| RS Enterprises | Doubtful (D2) | 30.00 | 30.00 | Fully secured |
| NPS & Sons | Loss | 1.00 | 1.00 | Only personal guarantee of proprietor (Net worth ₹50 lakhs) |

**Housing Loan and Car Loan**

A borrower Mr. Shyam has availed following two loans from the branch:

- Housing Loan: EMIs are overdue for 120 days as on March 31, 2024.
- Car Loan: EMIs are overdue for 60 days as on March 31, 2024.

**Agricultural Advances**

The branch has provided a loan of ₹20 lakhs under the Kisan Credit Card (KCC) scheme to a farmer for the cultivation of paddy, which has a harvest period of 3–4 months. There has been no transaction in the account for the last 90 days. The branch has classified the loan as a Standard Asset.

CA Dilip has clarified that the NPA classification has been verified and is in accordance with RBI guidelines. He instructed Shreyansh to focus on evaluating the adequacy of the provisions, considering RBI Guidelines mandate specific percentages for provisioning based on the NPA classification and the nature of the security.

**Based on the above facts, answer the following: -**

6. Is the provision made for AB Industries (Doubtful—D1) appropriate?

   (a) Yes, as it exceeds the required 25% provisioning for secured assets.

   (b) No, as it should be 40% of the outstanding amount.

   (c) No, as the required provision is ₹ 2.50 lakhs (25% of ₹ 10.00 lakhs).

   (d) Yes, as provisions for Doubtful assets can exceed the minimum requirement.

7. Considering the Housing Loan and Car Loan availed by the borrower Shyam, which of the following statements is appropriate?
   (a) Both Housing Loan and Car Loan should be classified as "Non-Performing Assets" in accordance with RBI norms on asset classification.
   (b) Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms. However, Car Loan should be classified as Standard Asset.
   (c) Car Loan should be classified as "Non-Performing Asset." However, Housing Loan should be classified as Standard Asset.
   (d) Both Housing Loan and Car Loan should be classified as Standard Assets.
8. What is the minimum provision required for RS Enterprises (Doubtful—D2), considering the account is fully secured?
   (a) ₹30.00 lakhs
   (b) ₹12.00 lakhs
   (c) ₹15.00 lakhs
   (d) ₹25.00 lakhs
9. As regards the description of the agricultural advance under Kisan Credit Card, which of the following statements is most appropriate?
   (a) The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset.
   (b) The classification made by the branch is proper. However, since there are no transactions in the account for 90 days, it is an SMA (Special Mention Account).
   (c) The classification made by the branch is proper.
   (d) The branch has erred in making classification as per RBI norms. It is a "Doubtful" asset.

**Case Scenario 3**

M/s MCP Associates are having 3 partners namely CA Mahavir, CA Chandana and CA Prabha. CA Mahavir is about to conclude audit of a company. During the audit, he noticed that there is a shortage of important raw material supplies being imported from China due to prevailing geopolitical situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter. The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate. He also verifies that all subsequent events have been accounted for and requests written representations from management, although the representations include qualifying language. Significant findings were communicated both orally and in writing to those charged with governance, with relevant communications documented.

CA Chandana is conducting an audit of a manufacturing company dealing in towels and bedspreads. The company's inventory is spread across its own locations and third-party premises. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing. She attends the physical inventory count, sends confirmation requests for trade receivables, and assesses controls. She relies on sampling extensively while auditing transactions, balances, and controls.

CA Prabha 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. She 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.

**Based on the above facts, answer the following: -**

10. Which of the following best describes CA Mahavir's responsibility for subsequent events as per SA 560?

    (a) He has no obligation to perform audit procedures for events occurring between date of financial statements and date of auditor's report.

    (b) He should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.

    (c) He has no obligation to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.

    (d) He has to only rely upon written representation of management regarding subsequent events. He has no other means to know about such events.

11. Which is the most appropriate action CA Chandana should take for verifying inventories held at third-party premises?

    (a) Request confirmation of the inventory's quantity and condition from third parties or inspect the inventory at their premises.

(b) Inspect all inventories at third-party premises without requesting confirmation.

(c) Rely on management's written representation regarding inventories at third-party locations.

(d) Confirm the inventory's value along with its quantity and condition from third parties.

12. Which audit procedure CA Prabha performed to verify whether conversion of foreign currency into Indian rupees is proper or not?

(a) Inspection

(b) Recalculation

(c) Observation

(d) Reperformance

**MCQs**

13. CA Kamal, a partner at KPS & Co., is conducting an audit of Ridhi Ltd., a manufacturing company. During the audit it was found that KPS & Co. generates 72% of its total revenue from Ridhi Ltd., raising concerns about the firm's financial dependence on this single client. Identify the kind of threat to independence that may be involved in this case.

(a) Familiarity threat

(b) Self-interest threat

(c) Self-review threat

(d) Advocacy threat

14. The auditor is evaluating the most appropriate method to assess the internal control system of the company. The selected method should be widely recognised for gathering information about the existence, operation, and efficiency of internal controls, while also minimizing the risk of oversight of important review procedures. Furthermore, the method should facilitate easier interim reviews of controls. Which method would be most appropriate for evaluating internal control based on the description provided above?

(a) Internal Control Questionnaire

(b) Flow Chart

(c) Check List

(d) Narrative Record

15. Gori told her friends that she had read a news report about how a company had misled its auditors by producing some fabricated documents. Which of the following statements seems to be appropriate in this regard?

    (a) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.

    (b) It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.

    (c) Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare, odd cases.

    (d) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.

## PART II - Descriptive Questions

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

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

1. (a) ABC Pvt. Ltd., a manufacturing company, is facing significant financial difficulties due to downfall in market and increase in cost of production. CA Ram, the auditor of ABC Pvt. Ltd. has identified the following conditions:

    - The company has defaulted on a major loan repayment.
    - Current liabilities exceed current assets by 50%.
    - Sales revenue has declined by 30% compared to the previous year.

    Management has not yet performed an assessment of the company's ability to continue as a going concern, but they provided assurance for implementing corrective measures, including cost-cutting initiatives and discussions with creditors for restructuring the loan.

    Which additional audit procedures need to be performed by CA Ram in accordance with SA 570 when such events or conditions are identified?

    **(5 Marks)**

    (b) CA Rishi is appointed as an auditor of AIR Ltd. for the financial year ending on March 31, 2024. During the audit, he observed that the company's books of accounts reflect a significant number of trade payables and receivables as on the balance sheet date. To verify the accuracy of the trade receivables, CA Rishi decided to send confirmation requests to some of trade receivables. However, the management refused to permit him to send these confirmation requests to the selected parties. How should the auditor proceed in the given situation? **(5 Marks)**

(c) CA Tanuj, the auditor of Kiran Ltd., completed the audit work and issued the auditor's report on 18th August 2024 for the financial year ended on 31st March 2024. During the final assembly of the audit file, he discarded some supporting schedules as same were outdated and corrected cross-referencing errors of working papers. No new audit conclusions were drawn, and the final audit file was assembled on 10th October 2024.

On the basis of Standards on Auditing regarding audit documentation, comment on the action taken by CA Tanuj. **(4 Marks)**

2. (a) Deepa Ltd., initially requested an audit engagement for the financial year 2023-2024. However, midway through the audit process, the management claims that they are unable to provide complete supporting documentation for a significant portion of their receivables. As a result, the management asks the auditor to change the audit engagement to a review engagement, arguing that it would prevent the issuance of a qualified opinion.

The auditor is now facing challenge in determining whether this change is justified or not. Comment in accordance with relevant SA. **(5 Marks)**

(b) CARO, 2020 shall apply to every company including foreign company. However, it specifically exempts certain class of companies. State which class of companies are specifically exempt from the applicability of CARO, 2020? **(5 Marks)**

(c) RST Ltd., a mid-sized trading company, recently faced challenges in securing a bank loan due to doubts about the reliability of its financial statements. The management realised the importance of having audited accounts to build confidence among lenders and other stakeholders. Elucidate the benefits and need of an audit. **(4 Marks)**

3. (a) During the audit of Smile Bank, CA Sweety focused on understanding the risk management process of the bank. She reviewed how management developed controls and used performance indicators to monitor key business and financial risks. CA Sweety also assessed whether the risk management system effectively identified and mitigated risks in required areas. How should CA Sweety evaluate the adequacy of the bank’s risk management controls? **(5 Marks)**

(b) Aman Cooperative Society appointed FAB & Associates as an auditor for the financial year 2023-2024. During the audit, the auditors noted the following details:

| | |
|---|---|
| Number of shares | 1000 shares @ ₹ 10/- each |
| Net Profit before compulsory transfer to reserve fund | ₹ 10,000/- |
| Net Profit after compulsory transfer to reserve fund | ₹ 8000/- |

(I) Mr. Dhairya, a member of society, holds 200 shares amounting to ₹ 2000 from the previous year.

(II) Upon verifying the society's borrowings, the auditors found that Cooperative Society had accepted a loan from Mr. Shivam, a non-member. The auditors did not find any restrictions regarding this in the society's bye laws.

Comment on the above transactions of the society with reference to the Co-operative Societies Act, 1912. **(5 Marks)**

(c) "In establishing the overall audit strategy, the auditor shall, among other considerations, ascertain the nature, timing and extent of resources necessary to perform the engagement". Explain those considerations in detail. **(4 Marks)**

4. (a) During the audit of HST Ltd., CA Mukund, the auditor, observed a significant volume of unsold electronic parts as inventory that had remained stagnant for more than two years. He noted that the company was facing difficulty selling these items due to the changes in the market. Additionally, some parts were damaged, and others were discontinued models. CA Mukund also ensured that the inventory was accurately valued to ensure proper financial reporting. You are required to outline the detailed audit procedures that are generally undertaken when auditing such inventories which at the time of observance of physical counting were noted as being damaged or obsolete. **(5 Marks)**

(b) 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. **(5 Marks)**

(c) Calen Retail Ltd. is preparing its annual financial statements, and the auditors are tasked with determining materiality. The company has used revenue as the benchmark, as it is a key indicator of performance. However, Calen Retail has recently opened new stores and closed underperforming ones, which could significantly affect both revenue and profitability. As per given case, what factors should the auditors consider when selecting the most appropriate benchmark for materiality? **(4 Marks)**

5. (a) M/s AR & Associates have been appointed as statutory auditors of Future Limited, a company engaged in the business of manufacturing of hardware products. They are analyzing the monthly trends for other expenses like rent, power and fuel, repairs, etc. and are also verifying attributes of such types of expenses. List down the attributes for verifying such expenses. **(5 Marks)**

(b) CA Kavita, auditor of Healthify Ltd., while assessing potential risks of material misstatement related to litigations at Healthify Ltd., identified a possible legal claim that could affect the financial statements. She sent a general inquiry letter to the company's external legal counsel, Mohit & Co., seeking clarification. However, Mohit & Co. informed her that their professional rules prohibited them from responding to these general inquiries. Guide CA Kavita that what other option is available to obtain the necessary information for the audit? **(5 Marks)**

(c) Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. Explain. **(4 Marks)**

6. (a) When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls **(5 Marks)**

(b) ASD Limited's business has grown from one state of India to various countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible?

**(5 Marks)**

(c) The management of PQ Ltd. changed during the period under audit. Mr. Govind, an auditor, at the time of receiving written representation on the management responsibilities from the management, was in a dilemma related to the date of and period(s) covered by the written representation. Further, new management was of the view that they can give written representation from the date they took over and not for the prior period when old management were managing affairs of the company. Guide the auditor and the management in this respect. **(4 Marks)**

**OR**

Knowledge of the Client's business play an important role in developing an overall audit. In fact, without adequate knowledge of the client's business, a proper audit is not possible. As per SA 315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Substantiate with the help of examples. **(4 Marks)**

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## INTERMEDIATE: GROUP – II

## PAPER – 5: AUDITING AND ETHICS

## SUGGESTED ANSWERS / HINTS

## Part I - Multiple Choice Questions

**1.** **(b)**
**2.** **(c)**
**3.** **(d)**
**4.** **(b)**
**5.** **(b)**
**6.** **(c)**
**7.** **(a)**
**8.** **(b)**
**9.** **(c)**
**10.** **(b)**
**11.** **(a)**
**12.** **(b)**
**13.** **(b)**
**14.** **(a)**
**15.** **(a)**

## Part II - Descriptive Answers

**1.** **(a)** SA 570, "Going Concern", deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

(i) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(ii) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

(iii) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:

(I) Evaluating the reliability of the underlying data generated to prepare the forecast; and

(II) Determining whether there is adequate support for the assumptions underlying the forecast.

(iv) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(v) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

**(b)** As per SA 505, "External Confirmation", If management refuses to allow the auditor to send a confirmation request, the auditor shall:

(i) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260 "Communication with Those Charged with Governance".

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

**(c)** As per SA 230, "Audit Documentation", the auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

- ♦ Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.
- ♦ After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

In the given situation, the auditor CA Tanuj has issued the auditor's report on 18th August 2024 for the financial year ended on 31st March 2024. However, he discarded some supporting schedules and corrected cross-referencing errors of working papers during the final assembly of the audit file by 10th October 2024 which is under prescribed time-limit of 60 days from the issuance of auditors report. Further, no new audit conclusions were drawn. Thus, CA Tanuj can make said changes to the audit documentation during the final assembly process.

**2.** **(a)** As per SA 210, "Agreeing the Terms of Audit Engagements", a request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Hence Deepa Ltd.'s request for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion is not reasonable.

**(b)** 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 (10 of 1949);

(ii) an insurance company as defined under the Insurance Act,1938 (4 of 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.

**(c)** Benefits and need of Audit:

- Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- Audited financial statements are helpful to government authorities for determining tax liabilities.
- Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.

**3. (a)** Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

(i) Oversight and involvement in the control process by those charged with governance: Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

(ii) Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(iii) Control activities: A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

(iv) Monitoring activities: Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.

(v) Reliable information systems: Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

**(b)** **Restrictions on share holdings:** - According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-.

**Restrictions on borrowings** - Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect."

In the given situation, Mr. Dhairya, a member of the society, is holding 200 shares amounting to ₹ 2000 from the previous year. In view of the aforementioned restriction on shareholding by a member, Mr. Dhairya is allowed to hold a maximum of 100 shares according to the Act.

Further, Aman Co-operative Society had accepted a loan from Mr. Shivam, a non-member. Since, there are no restrictions regarding the acceptance of loan received from non-member in the society's bye-laws, the loan received from Mr. Shivam is permissible.

**(c)** In establishing the overall audit strategy, the auditor shall:

(i) Identify the characteristics of the engagement that define its scope;

(ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

(iii) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

(iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(v) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

**4. (a)** Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory.

For the purpose, request the client to provide inventory ageing split and follow up for any inventories which at time of observance of physical counting were noted as being damaged or obsolete.

- Compare recorded costs with replacement costs.
- Examine vendor price lists to determine if recorded cost is less than current prices.
- Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, test overhead allocation rates and ensure that only direct labour, direct material and overhead have been included.
- Verify the correct application of lower-of- cost-or-net realizable value principles.

**(b) Relationship between audit strategy and 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 nature, timing and extent of audit procedures to be performed by engagement team 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, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.
- The 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.

**(c)** Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements like assets, liabilities, equity, revenue, expenses.
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused. For example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates, the entity's ownership structure and the way it is financed. For example, If an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings.
- The relative volatility of the benchmark.

**5.** **(a)** **Attributes for verifying other expenses like Power and Fuel, Repair etc.:** An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

(i) Whether the expenditure pertained to current period under audit;

(ii) Whether the expenditure qualified as a revenue and not capital expenditure;

(iii) Whether the expenditure had a valid supporting document like travel tickets, insurance policy, third party invoice etc.;

(iv) Whether the expenditure has been classified under the correct expense head;

(v) Whether the expenditure was authorised as per the delegation of authority matrix;

(vi) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

**(b)** If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(i) A list of litigation and claims;

(ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(iii) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

**(c)** **Familiarity threats:** Familiarity threats are self-evident and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways including:

(i) close relative of the audit team working in a senior position in the client company;

(ii) former partner of the audit firm being a director or senior employee of the client;

(iii) long association between specific auditors and their specific client counterparts; and

(iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

Provisions in Companies Act, 2013 regarding rotation of auditors mainly address these very familiarity threats. Such provisions prescribe that auditor is rotated after a certain number of years so that auditors do not become too familiar with their clients.

**6. (a) Matters the auditor may consider in determining the extent of test of controls include the following:**

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

**(b) Joint Audit of Financial Statements:** As per SA 299, "Joint Audit of Financial Statements", all the joint auditors shall be jointly and severally responsible for:

(i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

(ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;

(iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;

(iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;

(v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

(vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

**(c)** As per SA 580, "Written Representations", the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies. In view of above, management is required to provide the written representation for all the periods even when current management were not present during all periods referred to in the auditor's report.

**OR**

**(c)** As per SA 315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.

- ♦ Examples of matters the auditor may consider include market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.
- ♦ Relevant regulatory factors include the regulatory environment. The regulatory environment includes, among other matters, the applicable financial reporting framework and the legal and political environment.
- ♦ Examples of matters the auditor may consider include accounting principles and industry specific practices, regulatory framework for a regulated industry, legislation and regulation that significantly affect the entity's operations, including direct supervisory activities, taxation, government policies currently affecting the conduct of the entity's business, environmental requirements affecting the industry and the entity's business.
- ♦ Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation etc.