

MOCK TEST PAPER 1
FINAL COURSE: GROUP – I
PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS
SUGGESTED ANSWERS/HINTS

DIVISION A - MCQs (30 Marks)

Questions no. (1-10) carry 1 Mark each and Questions no. 11-20 carry 2 Marks each.

1. (b)
2. (c)
3. (d)
4. (a)
5. (b)
6. (d)
7. (c)
8. (a)
9. (d)
10. (c)

Questions (11-20) carry 2 Marks each

11. (b)
12. (b)
13. (c)
14. (b)
15. (a)
16. (c)
17. (c)
18. (b)
19. (c)
20. (b)

DIVISION B - DESCRIPTIVE QUESTIONS (70 Marks)

1. (a) **Acceptance and Continuance of Client Relationships and Audit Engagements** : As per SA 220, "Quality Control for an Audit of Financial Statements", SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- (i) The integrity of the principal owners, key management and those charged with governance of the entity.
 - (ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.
 - (iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and
 - (iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.
- (b) Audit report - Legal team anticipated tax liability but the company did not make any provision for that -**

The Council of the Institute of Chartered Accountants of India has taken note of the fact that there is a practice prevalent whereby companies do not make provision for tax even when such a liability is anticipated. It has expressed the view that on an overall consideration of the relevant provisions of law, non-provision for tax (where a liability is anticipated) would amount to contravention of the provisions of Sections 128 and 129 of the Companies Act, 2013.

Accordingly, it is necessary for the auditor to qualify his report and such qualification should bring out the manner in which the accounts do not disclose a "true and fair" view of the state of affairs of the company and the profit or loss of the company.

Applying the above to the facts given in the question, auditor should qualify his report.

An example of the manner in which the report on the balance sheet and the Statement of Profit and Loss may be qualified in this respect is given below: "The company has not provided for taxation in respect of its profits and the estimated aggregate amount of taxation not so provided for is ₹including.....for the Year ended onTo the extent of such non-provision for the year, the profits of the Company for the financial year under report have been overstated and to the extent of such aggregate non-provision, the reserves of the company appearing in the said balance sheet have been over-stated and the current liabilities and provisions appearing in the said balance sheet have been understated".

- (c) Reporting by the User Auditor:** As per SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation", the user auditor shall modify the opinion in the user auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

Thus, in view of above, contention of CA. Sheetal in removing reference of the work done by service auditor is in order as in case of unmodified audit report, user auditor cannot refer to the work done by service auditor.

- 2. (a)** SA 700 establishes requirements and provides guidance on forming an opinion on the financial statements. Communicating key audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation. SA 705, "Modifications to the Opinion in the Independent Auditor's Report", addresses circumstances in which the auditor concludes that there is a material misstatement relating to the appropriateness or adequacy of disclosures in the financial statements.

When the auditor expresses a qualified or adverse opinion in accordance with SA 705, presenting the description of a matter giving rise to a modified opinion in the Basis for Qualified (Adverse) Opinion section helps to promote intended users' understanding and to identify such circumstances when they occur. Separating the communication of this matter from other key audit matters described in the Key Audit Matters section, therefore, gives it the appropriate prominence in the auditor's report.

Further, when the auditor expresses a qualified or adverse opinion, communicating other key audit matters would still be relevant to enhancing intended users' understanding of the audit, and therefore the requirements to determine key audit matters apply. **However, as an adverse opinion is expressed in circumstances when the auditor has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements depending on the significance of the matter(s) giving rise to an adverse opinion, the auditor may determine that no other matters are key audit matters.**

In the given situation Moksh Ltd., a listed company, has not consolidated one of its subsidiary. Further, Consolidated Financial Statements of Moksh Ltd. Are materially misstated due to such non-consolidation. The material misstatement is also deemed to be material and pervasive and effect of the failure to consolidate have not been determined. In the given situation it is appropriate to give Adverse Opinion by XYZ & Co., a Chartered Accountant Firm.

Since, in the given case, Adverse Opinion is being expressed thus XYZ & Co. can communicate Key Audit Matter in given below manner:

Key Audit Matters: Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

- (b) **As per Clause 34 (b) of the Form 3CD, the auditor has to report whether the assessee is required to furnish the statement of tax deducted or tax collected. If yes, please furnish the details:**

Tax deduction and collection Account Number (TAN)	Type of Form	Due date for furnishing	Date of furnishing, if furnished	Whether the statement of tax deducted or collected contains information about all transactions which are required to be reported	If not, please furnish list of details/transactions which are not reported

Accordingly, clause 34 (b) requires, a list of details/transactions which are not reported in the statement of tax deducted at source and statement of tax collected at source are required to be furnished. The reporting requirement is notwithstanding the fact that the assessee has furnished the statements of tax deducted at source and tax collected at source within the prescribed time.

In the given situation, Rajul Ltd., has timely filed ETDS return for TDS deducted on Salary under section 192 of the Income Tax Act in Form 24Q in respect of 4th quarter. The company has not furnished list of details which are not reported in the statement of tax deducted at source under the pretext that TDS Statements are furnished within the prescribed time. Therefore, in view of above, Rajul Ltd. is required to furnish list of details which are not reported in the statement of tax deducted at source.

- (c) **Data Mining Techniques:**

- Data mining technique is a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information or patterns.

- ii. It discovers the usual knowledge or patterns in data, without a predefined idea or hypothesis about what the pattern may be, i.e. without any prior knowledge of fraud.
- iii. It explains various affinities, association, trends and variations in the form of conditional logic.
- iv. Data mining techniques are categorized in three ways: Discovery, Predictive modeling and Deviation and Link analysis.

In the given case of ATM Bank Ltd., CA Rani appointed as forensic auditor for its borrower, FAR Ltd, shall use above stated data mining techniques to identify any hidden patterns of information.

3. (a) Basic Requirements of a Trade Credit Insurance Product: An insurer shall offer trade credit insurance product only if all requirements mentioned below are met -

- (i) Policyholder's loss is non-receipt of trade receivable arising out of a trade of goods or services.
- (ii) Policyholder is a supplier of goods or services in consideration for a fair market value.
- (iii) Policyholder's trade receivable does not arise out of factoring or reverse factoring arrangement or any other similar arrangement.
- (iv) Policyholder has a customer (*i.e.*, Buyer) who is liable to pay a trade receivable to the policyholder in return for the goods and services received by him from the policyholder, in accordance with a policy document filed with the insurer.
- (v) Policyholder undertakes to pay premium for the entire Policy Period.
- (vi) Any other requirement that may be specified by the Authority from time to time.

(b) Significance of True and Fair: SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

In the context of audit of a company, the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of Schedule III to that Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the auditor will have to see that the accounts are drawn up in conformity with the provisions of Schedule III of the Companies Act, 2013 and whether they contain all the matters required to be disclosed therein. In case of companies which are governed by special Acts, the auditor should see whether the disclosure requirements of the governing Act are complied with.

It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for presenting a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a 'true and fair' view is the matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

- (i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
- (ii) no material asset is omitted;
- (iii) the charge, if any, on assets are disclosed;
- (iv) material liabilities should not be omitted;

- (v) the statement of profit and loss discloses all the matters required to be disclosed by Part II of Schedule III
 - (vi) the balance sheet has been prepared in accordance with Part I of Schedule III;
 - (vii) accounting policies have been followed consistently; and
 - (viii) all unusual, exceptional or non-recurring items have been disclosed separately.
- (c) As per Council General Guidelines, 2008, Chapter XV, Guidelines for Networking, once the relationship of network arises, it will be necessary for such a network to comply with all applicable ethical requirements prescribed by the Institute from time to time in general and the following requirements in particular in those cases where rotation of firms is prescribed by any regulatory authority, no member firm of the network can accept appointment as an auditor in place of any member firm of the network which is retiring.

In the given situation, AJ & Associates was statutory auditor of B Ltd. For last 10 years and due to rotation of auditor as per section 139(2) of the Companies Act, 2013 B Ltd., retires AJ & Associates and appoints PK & Co. as auditor for the year 2020-21.

It may be considered that AJ & Associates and PK & Co., chartered accountant firms have joined the network firm namely A to Z & Affiliates registered with Institute. In view of above Guidelines for Networking PK & Co., is disqualified for appointment as an auditor of B Ltd.

4 (a) **Obligation of auditor to submit an exception report to the RBI:**

- (I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:
 - (a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or
 - (b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or
 - (c) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

- (II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

- (b) **Operational audit**, (functional audit) as it is the audit for the management and involves verifying the effectiveness, efficiency and economy of operations done by the Chinmay travels for the organisation.

The operational auditor should possess some very essential personal qualities to be effective in his work:

1. In areas beyond accounting and finance, his knowledge ordinarily would be rather scanty, and this is a reason which should make him even more inquisitive.
2. He should ask the who, why, how of everything. He should try to visualise whether simpler

alternative means are available to do a particular work.

3. He should try to see everything as to whether that properly fits in the business frame and organisational policy. He should be persistent and should possess an attitude of skepticism.
4. He should not give up or feel satisfied easily. He should imbibe a constructive approach rather than a fault-finding approach and should give a feeling that his efforts are to help attaining an improved operation and not merely fault finding.
5. If the auditor succeeds in giving a feeling of help and assistance through constructive criticism, he will be able to obtain co-operation of the persons who are involved in the operations. This will itself be a tremendous achievement of the operational auditor. He should try to develop a team comprised of people of different backgrounds. Involvement of technical people in operational auditing is generally helpful.

- (c) **Putting Name Board of the Firm at Residence:** The Council of the Institute has decided that with regard to the use of the name-board, there will be no bar to the putting up of a name-board in the place of residence of a member with the designation of chartered accountant, provided, it is a name-plate or board of an individual member and not of the firm.

In the given case, partners Mr. Gautam and Mr. Mahaveer, put up a name board of the firm in both offices but not in their respective residences.

Conclusion: Thus, Mr. Gautam and Mr. Mahaveer are guilty of misconduct. Distance given in the question is not relevant for deciding.

5. (a) In the given scenario, Mr. Bharat was appointed as statutory auditor of two listed entities i.e., N Limited and O Limited. For the financial year 2021-22, Mr. Bharat had signed limited review reports for first three quarter i.e., till the quarter ended 31st December 2021 for both the companies. Owing to his personal commitments and increased workload, he resigned from N Limited and asked the Company to appoint another auditor to issue audit report for the remaining quarter and audit report for the FY 2021-22.

Further, Mr. Bharat immediately informed the management of O Limited that he had been disqualified to act as auditor and told them that he won't issue audit report for last quarter as Mrs. D (wife of Mr. Bharat) had borrowed a sum of ₹ 5.15 lakh from the Company for her personal use.

As per SEBI LODR Regulations, if the auditor has signed the limited review/ audit report for the first three quarters of a financial year, then the auditor shall, before such resignation, issue the limited review/ audit report for the last quarter of such financial year as well as the audit report for such financial year. This provision will not apply if the auditor is disqualified due to Section 141 of the Companies Act, 2013.

Thus, in the given situation, in view of above conditions to be complied with upon resignation of the statutory auditor of a listed entity/material subsidiary with respect to limited review / audit report as per SEBI LODR Regulations, Mr. Bharat is required to issue the audit report for the last quarter and audit report for the year 2021-22 for N Limited as he has issued audit report for the first three quarters whereas Mr. Bharat is not required to issue the audit report for remaining quarter and audit report for the year 2021-22 as a whole for O Limited as he is disqualified under section 141 of the Companies Act, 2013.

Accordingly, contention of Management of N Limited is correct and tenable for issuing the audit report for remaining quarter and audit report for financial year 2021-22 however, contention of management of O Limited is not correct regarding the legal responsibility of Mr. Bharat to issue audit report for remaining quarter and for the whole year.

- (b) CA. Ram conducting audit of branch of RICH Bank Ltd. whose principal business is lending money to large corporates. Many large accounts of this branch have turned NPA category and Management sold Shiva Ltd.'s NPA account amounting to ₹ 11 Crore to Asset Reconstruction Company.

CA. Ram should proceed as under:

In case of Sale of NPA by Bank, the auditor should examine

- (i) the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.
 - (ii) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
 - (iii) the assets have been sold "without recourse" only.
 - (iv) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.
 - (v) the NPA has been sold at cash basis only.
 - (vi) on the sale of the NPA, the same has been removed from the books of the account.
 - (vii) the short fall in the net book value has been charged to the profit and loss account.
 - (viii) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss because sale of other non-performing financial assets.
- (c) Engaging into a Business:** As per Clause (11) of Part I of First Schedule of Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he engages in any business or occupation other than the profession of Chartered Accountant unless permitted by the Council so to engage.

However, the Council has granted general permission to the members to engage in certain specific occupation. In respect of all other occupations specific permission of the Institute is necessary.

In this case, C.A. Bahubali is Special Executive Magistrate, engaged in the occupation of trading in commodity derivatives and also took over as the Executive Chairman on 01.04.2022.

In this context, it may be noted that the Special Executive Magistrate which is generally permitted for Members of the Institute in practice, further specific permission is required for holding the position of Executive Chairman and getting engaged in the occupation of trading in commodity derivatives.

In the given situation, C.A. Bahubali is acting as Special Executive Magistrate which is generally permitted for Members of the Institute in practice. Further, He is engaged in the occupation of trading in commodity derivatives which is not covered under the general permission. He also took over as the Executive Chairman for which specific permission is required. CA. Bahubali got the permission for the same from the Council of ICAI.

Conclusion: Hence, CA. Bahubali is not guilty for acting as Special Executive Magistrate as it is covered under the general permission. He is also not guilty for holding the position of Executive Chairman and getting engaged in the occupation of trading in commodity derivatives after getting specific permission of the Institute.

- 6 (a)** The areas covered in comprehensive audit naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. However, in general, the covered areas are those of investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc.

Some of the issues examined in comprehensive audit are:

- (i) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?
 - (ii) Have the planned production or operational outputs been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?
 - (iii) Has the planned rate of return been achieved?
 - (iv) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?
 - (v) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?
 - (vi) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?
 - (vii) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?
 - (viii) If the enterprise has an adequate system of repairs and maintenance?
 - (ix) Are procedures effective and economical?
 - (x) Is there any poor or insufficient or inefficient project planning?
- (b) Liability of Auditor:** “It is the auditor’s responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is satisfied with the books and documents produced to him, he can give his opinion on the basis of those documents only by exercising requisite skill and care and observing the laid down audit procedure. In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of M/s Dim Ltd. Therefore, he started investigation of books of accounts audited and signed by Mr. O, a practicing Chartered Accountant. While going through the books, he found that M/s Dim Ltd. Used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. O had negligently performed his duties.
- Mr. O, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is responsible for the books produced before him for audit. He completed his audit work with official set of books only.
- In this situation, as Mr. O, performed the auditing with due skill and diligence; and, therefore, no question of negligence arises. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.
- (c) Agreement on Audit Engagement Terms:** 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.
- Subject to prescribed details under Law or Regulations, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:
- (i) The objective and scope of the audit of the financial statements;
 - (ii) The responsibilities of the auditor;
 - (iii) The responsibilities of management;

- (iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

In the given scenario, NEW Limited appointed Mr. N, Mr. E and Mr. W, as its joint auditors for the year 2021-22 and issued engagement letter to all of them. The engagement letter contains the details on objective and scope of audit, responsibilities of auditor, identification of framework applicable and reference to expected form and content of report from all three joint auditors. However, engagement letter issued by NEW Ltd. does not specify the responsibilities of management, whereas as per SA 210, it should also specify responsibilities of management.

OR

- (c) Evaluating the professional judgment exercised by the auditor:** It is also important for the Technical Reviewer (hereinafter referred as TR) to understand that “professional judgment”, as defined in SA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing” is an integral concept in the context of an audit and application of SAs in real life audit scenarios. SA 200 defines professional judgment as “the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the course of action that is appropriate in the circumstances of the audit engagement.”

The concept of “professional judgment” underscores the fact that Standards, particularly, Standards on Auditing are written to lay down the fundamental principles that would apply to an audit situation. Hence, no Standard can have straight jacketed application/solutions for all audit scenarios. Above all, the Standards on Auditing issued by the Institute of Chartered Accountants of India are principle based rather than rule based. Hence, almost all the SAs envisage exercise of professional judgment by the auditor in their application in real life audit scenarios.

The TR would need to appreciate that the exercise of professional judgment in any particular case is based on the facts and circumstances that are known to the auditor as at the time of exercising that professional judgment. Normally, exercise of professional judgement by an auditor is preceded by consultation on the relevant matters both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm.

In evaluating the professional judgment exercised by the auditor, the TR should consider the following factors:

- whether the judgment reached reflects a due consideration and application of the relevant auditing and accounting principles; and
- whether the judgment is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor’s report. Hence, the TR and the QR Team should not, under any circumstance, use “hindsight” (i.e. perception or retrospection) in their evaluation of exercise of professional judgment by the auditor.

Since the auditor needs to exercise professional judgment throughout the audit, the latter also needs to be appropriately documented. Hence, the TR can expect to find such audit documentation as a part of the audit engagement file. It is important to note that professional judgment cannot be used by an auditor as a justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.