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PAPER-6: AUDITING AND ASSURANCE

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CONTENTS

CHAPTER-1
NATURE, OBJECTIVE AND SCOPE OF AUDIT

Q-1 "An audit is independent examination of financial information of any entity, whether profit orientedor not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Explain stating clearly how the person conducting this task should take care to ensure that financial statements would not mislead anybody.

Ans. "An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form.

   For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

   The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

   (i) the accounts have been drawn up with reference to entries in the books of account;

   (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;

   (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

   (iv) the information conveyed by the statements is clear and unambiguous;

   (v) the financial statement amounts are properly classified, described and disclosed in conformitywith accounting standards; and

   (vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

Q-2 The relationship between auditing and law is very close one.

Ans. **The relationship between au diting and law:** The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

Q-3 The firm's system of quality control should include policies and procedures addressing each and every element of system of quality control. State those elements.

Ans. **ELEMENTS OF A SYSTEM OF QUALITY CONTROL:** The firm's system of quality control should include policies and procedures addressing each of the following elements:

(a) Leadership responsibilities for quality within the firm.

(b) Ethical requirements.

(c) Acceptance and continuance of client relationships and specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

Q-4 SWM is proprietorship firm engaged in the manufacturing of different kind of yarns. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs.. 3 crores from Dena Bank. In the year 2018-19. Proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might not run well. He approaches an Internal Auditor about as to what would be covered in Audit. Advise regarding principal aspects (any four) to be covered in getting accounts audited.

Ans. The principal aspect to be covered in an audit concerning final statements of account are the following:

(i) **An examination of the system of accounting and internal control** to ascertain whether itis appropriate for the business and helps in properly recording all transactions.

(ii) **Reviewing the system and procedures** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) **Checking of the arithmetical accuracy of the books of account** by the verification of postings, balances, etc.

(iv) **Verification of the authenticity and validity of transaction** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.

(vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.

(viii) **Verification of the liabilities** stated in the balance sheet.

(ix) **Checking the result shown by the profit and loss** and to see whether the results shown are true and fair.

(x) **Where audit is of a corporate body, confirming that the statutory requirements** have been complied with.

(xi) **Reporting to the appropriate person/body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

Q-5 The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.

Ans. Ethical Requirements Relating to an Audit of Financial Statements: The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :

(a) Integrity;
(b) Objectivity;
(c) Professional competence and due care;
(d) Confidentiality; and
(e) Professional behavior.

Q-6 RAG is proprietorship firm engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of ₹ 30 crores. It has also availed cash credit limit of ₹ 5 crores from Canara Bank. In the year 2017-18, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches a CA about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited.

Ans. The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

(a) **It safeguards the financial interest of persons who are not associated** with the management of the entity, whether they are partners or shareholders,bankers, FI's, public at large etc.

(b) **It acts as a moral check on the employees** from committing defalcations or embezzlement.

(c) Audited statements of account are **helpful in settling liability for taxes**, negotiating loans and for determining the purchase consideration for a business.

(d) These are **also useful for settling trade disputes** for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also **help in the detection of wastages and losses** to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

(f) **Audit ascertains whether the necessary books of account and allied records have been properly kept** and helps the client in making good deficiencies or inadequacies in this respect.

(g) As an appraisal function**, audit reviews the existence and operations of various controls in the organisations** and reports weaknesses, inadequacies, etc., in them.

(h) Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner.**

(i) **Government may require audited and certified statement** before it gives assistance or issues a license for a particular trade.

Q-7 The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confide nce in the global auditing and assurance profession. Advise how this objective would be accomplished.

Ans. The objective of the IAASB is to serve the public interest by setting high quality auditing standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

Q-8 As per SA 220, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. While taking responsibility for the overall quality on each audit engagement, analyse and explain the emphasis of the actions of the engagement partner and appropriate messages to the other members of the engagement team . Also define engagement partner.

Ans. As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

(i) Performing work that complies with professional standards and regulatory and legal requirements;

(ii) Complying with the firm's quality control policies and procedures as applicable;

(iii) Issuing auditor's reports that are appropriate in the circumstances; and

(iv) The engagement team's ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

Engagement partner defined

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Q-9 The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. Explain.

Ans. The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. Self-review threats, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and

implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

3. Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.
4. 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: (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.
5. Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

Q-10 An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. Explain stating the factors based on which client can request the auditor to change the engagement.

Ans. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

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

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

Q-11 The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. Explain in the above context the purpose of monitoring compliance with quality control policies and procedures.

Ans. The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(a) Adherence to professional standards and regulatory and legal requirements;

(b) Whether the quality control system has been appropriately designed and effectively implemented; and

(c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

Q-12 The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

In the above context, explain the guiding principles.

Ans. The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Q-13 Write a note on "Self-review threats"

Ans. **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

Q-14 Explain the overall objective of the auditor as contained in SA 200.

Ans. As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

(i) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and

(ii) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

Q-15 Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. Explain stating also the qualities of Auditor.

Ans. **It is not enough to realise what an auditor should be.** He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.
He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, “an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true”.

Q-16 The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. Explain

Ans. **The auditor is not expected to, and cannot, reduce audit risk to zero** and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. The inherent limitations of an audit arise from:

(i) **The Nature of Financial Reporting**: The preparation of financial statements involves judgment by management in applying the requirements of the entity’s applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

(ii) **The Nature of Audit Procedures**: There are practical and legal limitations onthe auditor’s ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide,intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(iii) **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

(iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Q-17 As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should 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. Explain.

Ans. **Information which assist the Auditor in accepting and continuing of relationship with Client**: As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should 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. The following information would assist the auditor in accepting and continuing of relationship with the client:

(i) The integrity of the principal owners, key management and those charged withgovernance of the entity;

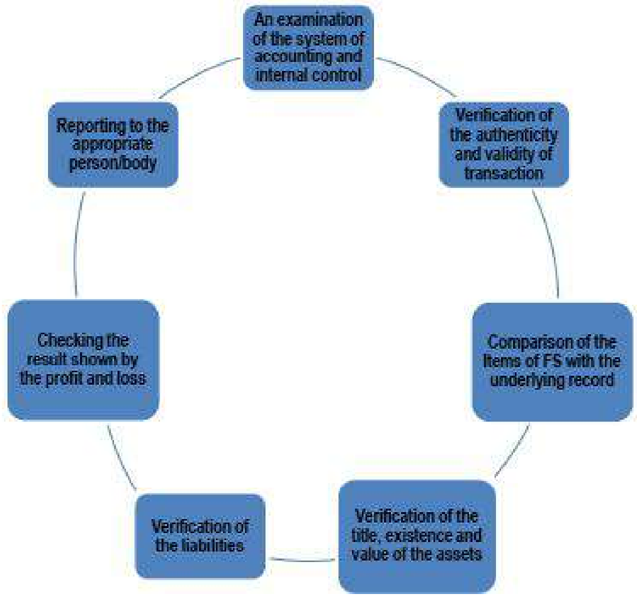
(ii) Whether the engagement team is competent to perform the audit engagementand has the necessary capabilities, including time and resources;

(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.

Q-18 GST & Co., a firm of Chartered Accountants has been appointed to audit the accountsof XYZ Ltd. The partner wanted to cover principal aspects while conducting its auditof financial statements. Advise those principal aspects.

Ans. The principal aspects to be covered in an audit concerning final statements of account are the following:



(i) **An examination of the system of accounting and internal control** to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

(ii) **Reviewing the system and procedures** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) **Checking of the arithmetical accuracy of the books of account** by the verification of postings, balances, etc.

(iv) **Verification of the authenticity and validity of transaction** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.

(vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.

Assertions about account balances at the period end:

(i) Existence—assets, liabilities, and equity interests exist.

(ii) Rights and obligations—the entity holds or controls the rights to assets, andliabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(viii) **Verification of the liabilities** stated in the balance sheet.

(ix) **Checking the result shown by the profit and loss** and to see whether the results shown are true and fair.

(x) **Where audit is of a corporate body, confirming that the statutory requirements**have been complied with.

(xi) **Reporting to the appropriate person/body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

Q-19 The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Explain.

Ans. Timeliness of Financial Reporting and the Balance between Benefit and Cost: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

Q-20 "An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so." Discuss.

Ans. **Acceptance of a Change in Engagement:** An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to-

(i) the original engagement; or

(ii) any procedures that may have been performed in the original engagement,except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall-

(i) Withdraw from the audit engagement where possible under applicable law orregulation; and

(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Q-21 "Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain.

Ans. Independence" implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of the entity subject to the audit. There are two interlinked perspective of independence of auditors, one independence of mind and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term "Independence" as comprising both-

(a) Independence of mind **–** the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(b) Independence in appearance **–** the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised." Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Q-22 "Professional judgment is essential to the proper conduct of an audit." Discuss.

Ans. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

(i) Materiality and audit risk.

(ii) The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.

(iii) Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.

(iv) The evaluation of management's judgments in applying the entity's applicable financial reporting framework.

(v) The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

Q-23 (a) The person conducting audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing.

(b) Explain the objectives of an Audit as per SA 200.

Ans.(a) "An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.

The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

(i) the accounts have been drawn up with reference to entries in the books of account;

(ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;

(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

(iv) the information conveyed by the statements is clear and unambiguous;

(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

(b) As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and

(b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

Q-24 (a) There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with examples.

(b) In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.

Ans.(a) The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(b) Other Matters that Affect the Limitations of an Audit: In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Q-25 The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. Discuss any four examples of professional skepticism.

Ans. **Professional skepticism includes being alert to, for example:**

(i) Audit evidence that contradicts other audit evidence obtained.

(ii) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.

(iii) Conditions that may indicate possible fraud.

(iv) Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

(v) Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

(a) Overlooking unusual circumstances.

(b) Over generalising when drawing conclusions from audit observations.

(c) Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Q-26 Mr. Z, a team member of auditor of Grateful and Competent Limited was of the opinion that while conducting an audit of a company no distinction is required to be made between revenue expenditure and capital expenditure.

Ans. **Incorrect:** The opinion of Mr. Z is incorrect because one of the important aspects to be followed while conducting audit of a company is that a distinction is required to be made properly between revenue expenditure and capital expenditure.

Q-27 The audit engagement letter is sent by the client to auditor.

Ans. **Incorrect**: As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.

Q-28 Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.

Ans. **Incorrect:** Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

Q-29 DEF & Co. Chartered Accountants successfully carried out the audit of Shree Garments for the f.y. 2019-2020. After the completion of the audit, there were found material misstatements due to fraud in the financial statements which were not noticed and reported by the auditor. Management alleges that it is failure on the part of auditor. Comment.

Ans. Because of the limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence. Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Q-30 There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. Explain.

Ans. There are two interlinked perspectives of independence of auditors , one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is: (i) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(ii) Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Q-31 "Professional judgment is essential to the proper conduct of an audit." Discuss .

Ans. **Professional judgment is essential to the proper conduct of an audit.** This is because interpretation of relevant ethical requirements and the SAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

(i) Materiality and audit risk.

(ii) The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.

(iii) Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.

(iv) The evaluation of management's judgments in applying the entity's applicable financial reporting framework.

(v) The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

Q-32 Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Explain giving examples.

Ans. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extentof the audit procedures and evaluating the results thereof.

Q-33 Both accounting and auditing are closely related with each other. Explain.

Ans. Both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the basis on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

Q-34 As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. Explain clearly stating the meaning of engagement partner and also the actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement.

Ans. As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

- (i) Performing work that complies with professional standards and regulatory and legal requirements;
- (ii) Complying with the firm's quality control policies and procedures as applicable;
- (iii) Issuing auditor's reports that are appropriate in the circumstances; and
- (iv) The engagement team's ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Q-35 The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice.

Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

Explain the purpose of monitoring compliance with quality control policies and procedures.

Ans. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(a) Adherence to professional standards and regulatory and legal requirements;

(b) Whether the quality control system has been appropriately designed and effectively implemented; and

(c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

Q-36 The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors. Explain giving examples.

Ans. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement

   Example

   An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.
4. The capabilities and competence of the individual team members performing the audit work.

   Example

   We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity's process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, along with the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior's involvement requires judgement, taking into consideration the complexity of the area and the experience of the team.

Q-37 Judging the significance of a matter requires an objective analysis of the facts and circumstances. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Explain with the help of examples.

Ans. **Documentation of Significant Matters and Related Significant Professional Judgments**

Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- Matters that give rise to significant risks.
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results.

Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

Q-38 The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties. Explain.

Ans. The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioural science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

Q-39 Discuss few guiding principles which are behind safeguards to eliminate threats to auditor's independence.

Ans. The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

(i) For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.

(ii) In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

(iii) Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

(iv) When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.

(v) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Q-40 The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Discuss the personnel issues addressed by such policies and procedures. Also explain how addressing the personnel issues would empower the firm.

Ans. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

Such policies and procedures address the following personnel issues:

(a) Recruitment;

(b) Performance evaluation;

(c) Capabilities;

(d) Competence;

(e) Career development;

(f) Promotion;

(g) Compensation; and

(h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

Q-41 There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain giving examples.

Ans. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Q-42 The person conducting the audit should take care to ensure that financial statements would not mislead anybody. Explain

Ans. The person conducting the audit should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

(i) the accounts have been drawn up with reference to entries in the books of account;

(ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;

(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

(iv) the information conveyed by the statements is clear and unambiguous;

(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

Q-43 In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters.

Ans. In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Q-44 Explain the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements in accordance with Code of Ethics issued by ICAI.

Ans. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Insti tute of Chartered Accountants of India.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles;

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behaviour.

Q-45 Describe the guiding principles which the auditor should take into account which serves as the safeguards to eliminate the threats to independence.

Ans. The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
4. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Q-46 The auditor shall obtain an understanding of major activities that the entity uses to monitor internal control over financial reporting. Discuss "Monitoring of control'' as a component of Internal control.

Ans. Monitoring of Controls: Component of Internal Control

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

Monitoring of controls Defined: Monitoring of controls is a process to assess the effective ness of internal control performance over time.

(i) Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

(ii) Management accomplishes through ongoing activities, separate evaluations etc.: Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

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

(iv) In case of Small Entities: Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Q-47 On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period. Explain the factors an auditor considers to be appropriate to revise the terms of the audit engagement or to remind the entity of existing terms.

Ans. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Q-48 The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard.

Ans. The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

(i) For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.

(ii) In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

(iii) Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

(iv) When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.

(v) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Q-49 Discuss preconditions for an audit as per SA 210. Explain how would an auditor proceed to establish the presence of pre conditions for an audit.

Ans. As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework is acceptable; and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;

(ii) For the internal control as management considers necessary; and

(iii) To provide the auditor with:

- ❖ Access to all information such as records, documentation and other matters;
- ❖ Additional information that the auditor may request from management for the purpose of the audit; and
- ❖ Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Q-50 **Through its policies and procedures,** the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished **through written or electronic manuals**, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Explain the matters to be addressed in this context.

Ans. The firm should establish **policies and procedures** designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished **through written or electronic manuals**, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials.

Matters addressed include the following:

- ❖ How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- ❖ Processes for complying with applicable engagement standards.
- ❖ Processes of engagement supervision, staff training and coaching.
- ❖ Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- ❖ Appropriate documentation of the work performed and of the timing and extent of the review.
- ❖ Processes to keep all policies and procedures current.

Q-51 The IESBA Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. Discuss and also explain the meaning of ethics.

Ans. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

First, broadly understand what are ethics? "Ethics" are the principles of conduct governing an individual or group. Professions like law, medicine have their code of ethics. Auditing profession is no exception. Rather, in profession of auditing,

importance of ethics is manifold.

The IESBA Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. We shall understand broad meaning and intent of these fundamental principles as under:-

(a) Integrity

Integrity requires auditor to be straight forward and honest in all professional and business relationships. It implies fair dealing and truthfulness. It effectively means that he shall not be associated with reports, returns, communications or other information which he believes contains a materially false or misleading statement; contains statements or information provided recklessly or omits required information where such omission could be misleading.

(b) Objectivity

The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

(c) Professional competence and due care

It requires that auditor attains and maintains professional knowledge and skill at the level required to render competent professional service based on current technical and professional standards and legislation and also to act diligently and in accordance with technical and professional standards. Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

(d) Confidentiality

Confidentiality principle requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

and

(e) Professional behaviour

It requires an auditor to comply with relevant laws and regulations and avoid any conduct that he knows or should know might discredit the profession.

Q-52 Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information." Explain in detail giving examples.

Ans. It is to be understood that Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information". Remember that Standards on auditing apply in "audit" of historical financial information which is a reasonable assurance engagement whereas Standards on Review Engagements apply in "review" of historical financial information which is a limited assurance engagement only.

"Historical financial information means" information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Here, we have to broadly understand that "audit" and "review" are two different terms. Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, "review" is a limited assurance engagement, and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement,

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.

Some examples of Standards on Auditing are :

(i) SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

(ii) SA 230 Audit Documentation

(iii) SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

(iv) SA 500 Audit Evidence

(v) Revised SA 700 Forming an Opinion and Reporting on Financial Statements Examples of Standards on Review engagements are

  (i) SRE 2400 (Revised) Engagements to Review Historical Financial Statements

  (ii) SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

Q-53 The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. Explain those threats in detail giving examples.

Ans. The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement,

(iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement. Like, in case an audit firm unduly relies on fees from a client, it may result in threat to self interest of auditor and he may not work objectively for the fear of losing client.

2. Self-review threats, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

3. Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes. In such situations, auditor can be perceived as backing and championing causes of auditee client and it may lead to belief that auditor is not acting and working objectively. Remember that auditor has not only to be independent but also appear to be acting so.

4. 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: (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.

5. Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation. Such threats attempt to intimidate auditors to deter them from acting objectively.

Q-54 CA S is requested to accept the appointment as an auditor of Luck Ltd. With reference to SA 210, what should the auditor determine in order to establish whether the preconditions for an audit are present?

Ans. **SA 210 – Agreeing the Terms of Audit Engagements:**

In order to establish whether the preconditions for an audit are present, the auditor of Luck Ltd, CA S shall:

(1) Determine whether the financial reporting framework is acceptable; and

(2) Obtain the agreement of management that it acknowledges and understands its responsibility:

   (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;

   (ii) For the internal control as management considers necessary; and

   (iii) To provide the auditor with:

- Access to all information such as records, documentation and other matters;
- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Q-55 M/s TP & Co., a firm of Chartered Accountants, is auditor of KSR Ltd. for many years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified or they are required to keep an open mind? Guide them.

Ans. **The Assistant Engaged – Be Encouraged to Keep an Open Mind:**

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally,

but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

In the given case, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the Company has diversified.

Q-56 Examine with reasons (in short) whether the following statements are correct or incorrect :

The preparation of financial statements involves judgment by management.

Ans. **Correct:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

Q-57 Discuss the following:

As an auditor of XYZ Ltd, how would you consider the acceptance of a change in audit engagement?

Ans. **Acceptance of a Change in Engagement:**

1. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.
2. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

3. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:
   (1) the original engagement; or
   (2) any procedures that may have been performed in the original engagement, except

   where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.
4. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.
5. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
6. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:
   (a) Withdraw from the audit engagement where possible under applicable law or regulation; and
   (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Q-58 While conducting audit of VED Ltd., you as an auditor are not only prevented in completing certain audit procedures but also are not able to obtain audit evidence even by performing alternative procedures. How you will deal with this situation?

Ans. As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", i f, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor sh all request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

(1) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or

(2) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
   (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
   (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

   If the auditor withdraws, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Q-59 Discuss the following:

The auditor has to form an opinion on the financial statements within a reasonable period of time and at a reasonable cost. Explain the above statement with reference to "Timeliness of Financial Reporting and the Balance between Benefit and Cost".

Ans. **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opi nion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

MULTIPLE CHOICE QUESTIONS

1. Most of the auditor's work in forming the auditor's opinion consists of :

(a) obtaining audit evidence.
(b) evaluating audit evidence.
(c) obtaining or evaluating audit evidence.
(d) obtaining and evaluating audit evidence.

2. Professional skepticism is necessary to the critical assessment of

(a) audit documentation
(b) audit evidence.
(c) audit procedures
(d) All of the above

3. According to SA 210 "Agreeing the Terms of Audit Engagements", The auditor shall agree the terms of the audit engagement with :

(a) management
(b) those charged with governance
(c) management or those charged with governance, as appropriate.
(d) Audit committee

4. The matter of difficulty, time, or cost involved is :

(a) not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
(b) in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.
(c) not in itself a valid basis for the auditor to omit an audit procedure for which alternative exists.
(d) not in itself a valid basis for the auditor to omit an audit procedure.

5. _____are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.

(a) Self-review threats
(b) Familiarity threats
(c) Intimidation threats
(d) Advocacy threats

6. The type of errors, existence of which becomes apparent in the process of compilation of accounts is known as-

(a) Self-revealing errors.
(b) Intentional errors.
(c) Concealed errors.
(d) Unconcealed errors.

7. If the auditor concludes that there is reasonable justification to change the engagement and if the auditwork performed complied with the SAs applicable to the changed engagement, the report issued wouldbe appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

(a) the original engagement; or any procedures that may have been performed in the original engagement.

(b) the original engagement;

(c) any procedures that may have been performed in the original engagement

(d) the original engagement and any procedures that may have been performed in the originalengagement.

8. Which of the following is correct :

(a) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtainabsolute assurance that the financial statements are free from material misstatement due to fraudor error.

(b) The auditor is expected to and can reduce audit risk to zero and can therefore obtain absoluteassurance.

(c) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtainreasonable assurance that the financial statements are free from material misstatement due tofraud or error.

(d) The auditor is expected to and can reduce audit risk to zero and can therefore obtain reasonableassurance that the financial statements are free from material misstatement due to fraud or error.

9. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves theexercise of ___________

(a) Independence **(b) Professional Judgement**

(c) Professional skepticism (d) All of the above

10. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of _________exercised in performing the work and evaluating the results.

(a) professional skepticism (b) professional integrity

(c) professional judgment (d) Professional sincerity

11. M/s KYC & Co. is a reputed Audit firm in Mumbai. They are appointed as Statutory Auditors of Blessed Ltd. Which of the below is the responsibility of M/s KYC & Co.

(a) Preparation of financial statements

(b) Designing, implementation and maintenance of internal control system

(c) Reporting on true and fair view of financial statements

(d) Compliance with the applicable law and regulation

12. Mr. A, auditor and Mr. B, Finance Manager of XYZ Pvt Ltd are friends. Mr. A prepares the audit report according to the wishes and directions of Mr. B. In this situation which essential quality of the auditor has been compromised:

(a) Professional Competence **(b) Independence**

(c) Professional Skepticism (d) Due care

13. Mr. Salman, is an engagement partner of Khan & co. chartered accountants for an audit of Lava Ltd., he died of a stroke on 30.09.2019 after completing the entire routine audit work of Lava Ltd. Mr. Shoaib, one of the partners of Khan & Co. will be signing the accounts of Lava Ltd. What is the course of action to be taken by Mr. Shoaib?

(a) Sign the accounts of Lava Ltd without reviewing the work of his partner

(b) Sign the balance sheet after reviewing the work of his partner

(c) Withdraw the audit as the person who has performed the audit is no more

(d) Issue an adverse report

14. The Firm R K & Associates has an extensive understanding of Code of Ethics that underlies the fundamental principles relevant to the Auditor when conducting an Audit of Financial Statements and provides a conceptual framework for applying these principles. Which of the following does not form part of the fundamental principle?

(a) Integrity

(b) Professional Competence and due care

(c) Professional Skepticism

(d) Professional behaviour

Case Scenario 1

<u>Integrated case study</u>

Mr. Laxman is appointed as statutory auditor of Best Limited for the Financial Year ended 31st March, 2020. During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2020.

The fraud was going on since last 4-5 years and the total amount misappropriated is approximately ₹ 75 lacs. Balance sheet of Best Ltd. reflected a cash balance of ₹ 7 crores. The company has taken a loan of ₹ 2 crores from the bank despite of the huge cash balance with the company.

Also, Companies Act bestows some duties on auditors to report matters to Central Government in case of fraud.

On the basis of above facts answer below questions in relation to Mr . Laxman's role and duties while conducting statutory audit of Best Limited.

1. Mr. Laxman shall obtain ____________________ that the financial statements are free from fraud and misstatement.

(a) Absolute assurance	**(b) Reasonable assurance**
(c) Management's assurance	(d) Chief Financial Officer assurance

2. Owing to the _______ limitations of an audit, there is _________ risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

(a) Inherent, unavoidable	(b) Inherit, complete
(c) Management, unavoidable	(d) Regulatory, control

❑

NOTES

CHAPTER-2
AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

Q-1 "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business" Discuss stating clearly the broad points you would be covering in framing plan to conduct audit in an efficient and effective manner.

Ans. "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

(a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(b) establishing the expected degree of reliance to be placed on internal control;

(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit. SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. 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.

Q-2 The establishment of the overall audit strategy and the detailed audit plan are closely inter-related. Explain.

Ans. 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.

Q-3 The engagement partner of AST AND ASSOCIATES, firm of Chartered Accountants appointed as auditor of Fabric India Ltd is considering as to management of key resources to be empl oyed to conduct audit. Discuss how overall audit strategy would assist the auditor.

Ans. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;

2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and

4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place **(for example, on-site or off-site),** and whether to complete engagement quality control reviews.

Q-4 As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan. Explain.

Ans. **The auditor shall update and change the overall audit strategy** and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. **For example,** audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Q-5 Engagement partner of Audit Firm MKC AND COMPANY thinks that Planning an audit would involve establishing the overall audit strategy for the engagement and developing an audit plan. Also, Adequate planning would benefit the audit of financial statements in several ways. Analyse explaining the benefits of adequate planning.

Ans. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

1. Helping the auditor to devote appropriate attention to important areas of the audit.

2. Helping the auditor identify and resolve potential problems on a timely basis.

3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

5. Facilitating the direction and supervision of engagement team members and the review of their work.

6. Assisting, where applicable, in coordination of work done by auditors of components and experts.

Q-6 Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Analyse and Explain.

Ans. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

Q-7 Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain

Ans. **Businesses vary in nature, size and composition;** work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

Q-8 The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. Explain

Ans. **Periodic Review of The Audit Programme** : There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

Example- if the audit programme for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [*Pacific Acceptance Corporation Ltd.* v. *Forsyth and Others.*]

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assist-ant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

Q-9 Explain the significant points auditor would consider while developing an audit programme.

Ans. **Developing the Audit Programme :**

1. **Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

2. **Audit objective and instruction to assistants**: The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
3. **Reliance on Internal Controls**: In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.
4. **Timings of performance of audit procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.
5. **Audit planning:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

Q-10 The auditor shall document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. Explain

Ans. **The auditor shall document :**

(a) the overall audit strategy;

(b) the audit plan; and

(c) any significant changes made during the audit engagement to the overall auditstrategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

For instanceThe following things should form part of auditor's documentation :

- A summary of discussions with the entity's key decision makers
- Documentation of audit committee pre-approval of services, where required
- Audit documentation access letters

- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services
- auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter)

Q-11 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. Discuss stating the factors that may affect the identification of an appropriate benchmark.

Ans. 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

  Example - 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

  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 and

  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

Q-12 Arpana Hospitals Ltd having Gross Professional Charges of ` 50 crores is engaged in providing healthcare services. STP & Co., a firm of auditors is appointed as its auditors.

Advise what special points to be kept in mind for the purpose of construction of an Audit programme. Explain.

Ans. For the purpose of programme construction, the following points should be kept in mind

(1) Stay within the scope and limitation of the assignment.

(2) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

(3) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(4) Consider all possibilities of error.

(5) Co-ordinate the procedures to be applied to related items.

Q-13 M & Co. was appointed as auditor of IGI Ltd. As an auditor what are the factors that would be considered in the development of overall audit plan?

Ans. Development of an Overall Plan: The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.

- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

Q-14 Plans should be further developed and revised as necessary during the course of the audit. Explain.

Ans. Plans should be further developed and revised as necessary during the course of the audit.

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, **planning is not a discrete phase of an audit, but rather a continual and iterative process** that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. 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.

Q-15 (a) Knowledge of the Client's business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of 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.

(b) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques.

Analyse and explain with the help of example of evidence in respect of Sales.

Ans.(a) Examples are :

- The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.
- Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
- Technological developments, such as those related to the entity's products, energy supply and cost.
- The effect of regulation on entity operations.

(b) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

Example

Sales are evidenced by:

(i) invoices raised by the client;

(ii) price list;

(iii) forwarding notes to client;

(iv) inventory-issue records;

(v) sales managers' advice to the inventory section;

(vi) acknowledgements of the receipt of goods by the customers; and

(vii) collection of money against sales by the client.

Q-16 In establishing overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elucidate those cases by which auditor can ascertain the reporting objectives of the engagement.

Ans. **In establishing the overall audit strategy**, auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. The cases by which auditor can ascertain the reporting objectives of the engagement are:

(i) The entity's timetable for reporting, such as at interim and final stages.

(ii) The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.

(iii) The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.

(iv) The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

Q-17 A detailed Audit Programme once prepared for a business can be used for all business under all circumstances.

Ans. **Incorrect.** Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

Q-18 Your firm has been appointed as an auditor to audit the accounts of an auto parts manufacturer, ABC LTD. Elucidate the matters to be considered by an auditor in developing his overall plan for the expected scope and conduct of audit.

Ans. **Ans.Development of an Overall Plan:** The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit -

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.

- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

Q-19 State with reason (in short) whether the following statements are true or false:

Overall audit plan sets the scope, timing and direction of the audit, and guides the development of the more detailed audit strategy.

Ans. **Incorrect:** Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Q-20 The auditor shall document the overall audit strategy, the audit plan and any significant changes made to the overall audit strategy or the audit plan. Explain in detail giving examples.

Ans. The auditor shall document:

(a) the overall audit strategy;

(b) the audit plan; and

(c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate signi ficant matters to the engagement team.

Example

The auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Example

The following things should form part of auditor's documentation:

- A summary of discussions with the entity's key decision makers.
- Documentation of audit committee pre-approval of services, where required.
- Audit documentation access letters.
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.
- Auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter).

Q-21 Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain clearly stating in detail the meaning of audit programme.

Ans. Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

Definition : An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

Q-22 The auditor shall document the overall audit strategy, the audit plan, and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. Explain.

Ans. **The auditor shall document :**

(a) the overall audit strategy;

(b) the audit plan; and

(c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

For instance-

The following things should form part of auditor's documentation:

- A summary of discussions with the entity's key decision makers
- Documentation of audit committee pre-approval of services, where required
- Audit documentation access letters
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services
- auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter)

Q-23 Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example.

Ans. **Revision in Materiality level as the Audit Progresses:** Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

Example

If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Q-24 State the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Ans. **Audit Sampling:** As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Q-25 With Ref. to SA 320 "Materiality in planning and performing an audit" Indicate the factors which may effect the identification of an appropriate benchmark while determining materiality for the financial statements as a whole.

Ans. 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 (Example - 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 (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 and (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.

Q-26 Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with relevant SA, knowledge to be obtained by the auditor in establishing overall plan.

Also explain how such an understanding would be helpful to the auditor.

Ans. Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. 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 following:

(a) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.

(b) The nature of the entity, including:

  (i) its operations;

  (ii) its ownership and governance structures;

  (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

  (iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations and to make judgements regarding the appropriateness of accounting policies and disclosures.

Q-27 Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes the need to consider certain matters prior to the auditor's identification and assessment of the risks of material misstatement. Explain clearly stating those matters also.

Ans. In the context of recurring audits, as per SA-300, "Planning an Audit of Financial Statements", Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

Q-28 The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, explain the auditor's assumptions about users of the financial statements.

Ans. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(i) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(ii) Understand that financial statements are prepared, presented and audited to levels of materiality;

(iii) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(iv) Make reasonable economic decisions on the basis of the information in the financial statements.

Q-29 Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain

Ans. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

1. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
2. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
3. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Q-30 Engagement Partner CA Hitesh Kapur of Kapur and Associates wanted to develop an audit plan of Sampurna Fabrics Ltd. Discuss the matters to be described in such an audit plan.

Ans. **The auditor shall develop an audit plan that shall include a description of :**

(i) The nature, timing and extent of planned risk assessment procedures, asdetermined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

(ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

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.

Example

Planning of the auditor's risk assessment procedures occurs early in the audit process.

However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Q-31 Without adequate knowledge of client's business, a proper audit is not possible. The auditor shall obtain an understanding of the entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. Explain giving examples.

Ans. Knowledge of the client's business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of 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 entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

Example

1. If one of management's objectives is to grow the business, management may develop a strategy of steady but regular growth through specific marketing campaigns and development of new markets. Alternatively, management may develop a more aggressive, complex strategy of acquiring competitors. Each of these strategies gives rise to differing business risks and potentially differing risks of material misstatement.
2. Examples of potential business risks include:
   (i) Failure to keep up to date with new products, technologies or services.

(ii) Excessive reliance on a key supplier, product or individual, such as the owner.

(iii) Lack of personnel with expertise to react to changes in the industry.

(iv) Insufficient or excessive production capacity caused by inaccurate **estimation of demand.**

- Loss of financing due to the entity's inability to meet financial covenants

Q-32 You are being appointed as the auditor of Track Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of an appropriate benchmark?

Ans. **SA 320 "Materiality in Planning and Performing an Audit"** prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

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:

i. **The elements of the financial statements** (for example, assets, liabilities, equity, revenue, expenses);

ii. 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);

iii. **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.

iv. **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); and

v. The **relative volatility** of the bench.

Q-33 State with reasons whether the following statements are correct or incorrect.

When Profit before tax from continuing operations is non-volatile, other benchmarks will be appropriate.

Ans. **Incorrect:** Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Q-34 Examine with reasons (in short) whether the following statements are correct or incorrect :

Evolving one audit programme applicable to all business under all circumstances is not practicable

Ans. **Correct**: Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

Q-35 Discuss: CA Vikas Jain discussed with his audit team about advantages and disadvantages of audit programme. He explained to his team that –"work may become mechanical" as disadvantage of the audit programme. Discuss explaining the disadvantages of an audit programme

Ans. **Some disadvantages are there in the use of audit programme. 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.

Q-36 You have been appointed as an auditor of MKP Ltd. for the first time. Discuss briefly, the factors to be considered by you while establishing overall audit strategy.

Ans. As per SA-300, "Planning an Audit of Financial Statements", 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. 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.

MULTIPLE CHOICE QUESTIONS

1. Planning an audit involves

(a) establishing the overall audit strategy for the engagement and developing an audit plan.

(b) establishing the overall audit plan for the engagement and developing an audit strategy.

(c) establishing the overall audit plan for the engagement

(d) developing an audit strategy.

2. According to SA 300,

(a) planning is not a continual and iterative phase of an audit, but rather a discrete process

(b) planning is not a discrete phase of an audit, but rather a continual and iterative process

(c) planning is not continual and iterative process

(d) planning is not a discrete phase of an audit

3. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor

(a) should not consider materiality and its relationship with audit risk while conducting an audit.

(b) should consider materiality and its relationship with audit risk while conducting an audit.

(c) should not consider materiality but should consider its relationship with audit risk while conducting an audit.

(d) should consider materiality but need not consider its relationship with audit risk while conducting an audit.

4. When planning the audit,

(a) the auditor considers what would make the financial information materially misstated.

(b) the auditor need not consider what would make the financial information materially misstated.

(c) the auditor need not consider what would make the financial information materially misstated at planning stage

(d) the auditor needs to consider what would make the financial information materially misstated while conducting audit only

5. CA. Bobby is a recently qualified Chartered Accountant. He is appointed as an auditor of Droopy Ltd. for the current Financial Year 2017-18. He is quite conservative in nature which is also replicated in his professional work. CA. Bobby is of the view that he shall record all the matters related to audit, audit procedures to be performed, audit evidence obtained and conclusions reached. Thus, he maintained a file and recorded each and every of his findings during the audit. His audit file, besides other thing, includes audit programmes, notes reflecting preliminary thinking, letters of confirmation, e-mails concerning significant matters, etc. State which of the following need not be included in the audit documentation?

(a) Audit programmes.

(b) Notes reflecting preliminary thinking.

(c) Letters of confirmation.

(d) E-mails concerning significant matters.

6. The concept of materiality is applied by the auditor :

(a) in planning and performing the audit

(b) in evaluating the effect of identified misstatements on the audit

(c) both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit

(d) none of the above is correct

7. CA R illustrated to his team that the utility of the Audit Programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under recurrent assessment. Which attribute of the Audit Programme is highlighted here?

(a) Static Review

(b) Mechanical Review

(c) Periodic Review

(d) Obsolete Review

❑

CHAPTER-3
AUDIT DOCUMENTATION AND AUDIT EVIDENCE

Q-1 The auditors should consider the effect of subsequent events on the financial statement and on auditor's report"– Comment according to SA 560.

Ans. **Effect of Subsequent Events:** SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events , the auditor should-

(i) obtain an understanding of any procedures management has established to ensure thatsubsequent events are identified.

(ii) inquire of management and, where appropriate, those charged with governance as to whetherany subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether there have been any developments regarding contingencies.
- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

(iii) Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(iv) Read the entity's latest subsequent interim financial statements, if any.

(v) Read the entity's latest available budgets, cash flow forecasts and other related managementreports for periods after the date of the financial statements.

(vi) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.

(vii) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

Q-2 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. Discuss.

Ans. 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. SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. 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.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

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.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Q-3 Audit documentation provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. Explain stating clearly purpose of audit documentation.

Ans. **Nature of Audit Documentation**

Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Purpose of Audit Documentation

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Q-4 Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the detailed meaning of audit evidence.

Ans. Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) **Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Q-5 Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain.

Ans. **Audit evidence is necessary to support the auditor's opinion and report.** It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

Q-6 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 realize its assets and discharge its liabilities in the normal course of business. Explain stating also the objective of the auditor regarding going concern.

Ans. 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. 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 realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern

The objectives of the auditor are:

(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor. **.**

Q-7 Discuss the meaning and nature of Audit Documentation.

Ans. **Audit documentation:** SA 230 on "Audit Documentation", audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Nature of Audit Documentation

Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Q-8 Explain clearly objective of the auditor regarding written representation.

Ans. **The objectives of the auditor regarding written representation**

The objectives of the auditor are:

(a) To obtain written representations

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other evidence

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(c) To respond appropriately

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Q-9 The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Explain.

Ans. **Audit Procedure Regarding Events Occurring Between The Date Of The Financial Statements And The Date Of The Auditor's Report**

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements **have been identified**.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

Q-10 There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements. Analyse and explain stating the responsibility of auditor in this regard.

Ans. **Responsibilities of the Auditor**

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

(a) Achieve a true and fair presentation; or

(b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
- Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

Q-11 The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. Analyse and Explain stating clearly the factors affecting the auditor's judgement as to sufficiency of audit evidence.

Ans. **Sufficiency of Audit Evidence:** Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor's judgment as to sufficiency may be affected by the factors such as:**

(i) Materiality

(ii) Risk of material misstatement

(iii) Size and characteristics of the population.

(i) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(ii) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) **Size of population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Q-12 The form, content and extent of audit documentation depend on factors such as the size and complexity of the entity, the nature of the audit procedures to be performed etc. Explain in detail.

Ans. The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

Q-13 A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Explain.

Ans. **Tests of controls:** Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate auditevidence at the assertion level.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Q-14 Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. Analyse and explain.

Ans. **Irrespective of the assessed risks of material misstatement,** the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:
   (i) the auditor's assessment of risk is judgmental and so may not identify allrisks of material misstatement; and
   (ii) there are inherent limitations to internal control, including managementoverride.
2. Depending on the circumstances, the auditor may determine that:
   - Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
   - Only tests of details are appropriate.
   - A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.
4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

Q-15 External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. Analyse and Explain.

Ans. **External confirmation procedures frequently are relevant** when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.

- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

Q-16 State the significant difficulties encountered during audit with reference to SA-260 (communication with those charged with governance).

Ans. **Significant Difficulties Encountered During the Audit:** As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

Q-17 Evaluating responses to inquiries is an integral part of the inquiry process. Explain .

Ans. **Inquiry – Audit Procedure to obtain Audit Evidence:** Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

Q-18 The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of AB Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter.

Analyse how would you deal as an auditor.

Ans. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

Q-19 "Completion Memorandum" is helpful as part of the audit documentation. Explain.

Ans. Completion Memorandum or Audit Documentation Summary.

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

(i) the significant matters identified during the audit.

(ii) how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Q-20 The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. Explain the auditor's obligation in the above situation.

Ans. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements.

Q-21 (a) The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

(b) When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

Ans.(a) Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.

- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

(b) When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

Q-22 (a) Define the following :

(i) Positive confirmation request

(ii) Negative confirmation request

(iii) Non-response

(iv) Exception

Ans.(a) Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

Q-23 There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with the help of examples.

Ans. **The Nature of Audit Procedures**: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it.

   Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Q-24 Give some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment where the matters and judgments are significant.

Ans. Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

Q-25 Auditors of M/s Tender India (P) Ltd. were changed for the accounting year 2016-17. The closing inventory of the company as on 31.3.2016 amounting to Rs. 100 lacs continued as it is and became closing inventory as on 31.3.2017. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.

Ans. **Verification of Inventory:** As per SA 510 "Initial Audit Engagements – Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

(i) Opening balances contain misstatements that materially affect the current period's financialstatements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by predecessor auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date. The contention of the management that the inventory has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude the audit of closing inventory from his audit programme.

Q-26 Briefly mention the matters that are relevant in planning attendance at physical inventory counting.

Ans. **Matters relevant in planning attendance at physical inventory counting:Matters relevant in planning attendance at physical inventory counting include, for example :**

(i) Nature of inventory.

(ii) Stages of completion of work in progress.

(iii) The risks of material misstatement related to inventory.

(iv) The nature of the internal control related to inventory.

(v) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(vi) The timing of physical inventory counting.

(vii) Whether the entity maintains a perpetual inventory system.

(viii) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate

(ix) Whether the assistance of an auditor's expert is needed.

Q-27 "Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability". Explain. Also state clearly generalisations about the reliability of audit evidence.

Ans. **Reliability of Audit Evidence:** SA 500 on "Audit Evidence" provides that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

(1) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

(2) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

(3) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

(4) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

(5) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Q-28 In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. An auditor picks up evidence from a variety of fields.Analyse and explain with the help of examples.

Ans. In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion. An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

(a) Documentary examination,

(b) Physical examination,
(c) Statements and explanation of management, officials and employees,
(d) Statements and explanations of third parties,
(e) Arithmetical calculations by the auditor,
(f) State of internal controls and internal checks,
(g) Inter-relationship of the various accounting data,
(h) Subsidiary and memorandum records,
(i) Minutes,
(j) Subsequent action by the client and by others.

Example

1. For cash in hand, the best evidence is “count”
2. For investment pledged with a bank, the banker’s certificate.
3. For verifying assertions about book debts, the client’s ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary.

   In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word “available” we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

Q-29 M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach?

Ans. Initial audit engagement is an engagement in which either :

(i) The financial statements for the prior period were not audited; or
(ii) The financial statements for the prior period were audited by a predecessor auditor.

From the above, it is quite clear that CA Pankaj is not correct *in* his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

Audit Procedures regarding Opening Balances; The auditor shall read the most recent financial statements, if any, and the predecessor auditor’s report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period’s financial statements by:

(a) Determining whether the prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year’s Statement of Profit and Loss;
(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
(c) Performing one or more of the following:

(i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

Q-30 In the course of audit of SMP Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ‘ 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing.

Ans. **Certificate from a Management's Expert:** In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.

The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

As per SA 500, "Audit Evidence", 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:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Q-31 Explain the objectives of the auditor regarding written representations.

Ans. **The objectives of the auditor regarding written representation:**

(i) To obtain written representations

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(ii) To support other evidence

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(iii) To respond appropriately

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Q-32 Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered. Further, it is unnecessary for the auditor to document separately compliance with matters for which compliance is demonstrated by documents included within the audit file. Explain giving examples.

Ans. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
- For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315.

Q-33 Documentation of audit plan serves as a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. What all activities in the planning phase should form part of auditor's documentation? State with examples.

Ans. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

Example

The following things should form part of auditor's documentation

- A summary of discussions with the entity's key decision makers.
- Documentation of audit committee pre-approval of services, where required.
- Audit documentation access letters.
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.
- Auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter).

Q-34 CA Rohit is appointed as an auditor of Grace Ltd., he wants to design a suitable confirmation request letter for a few debtors of Grace Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level.

Ans. **Negative confirmations** is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative information provide less persuasive audit evidence than positive confirmations. Accordingly, CA Rohit, Auditor of Grace Ltd, 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:

(a) 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;

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

(c) A very low exception rate is expected; and

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

Q-35 CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations.

Ans. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

Examples of audit procedures which include observation or inspection of the entity's operations are:

(1) Documents (such as business plans and strategies), records, and internal control manuals.

(2) Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)

(3) The entity's premises and plant facilities.

Q-36 Management's assessment of the entity's ability to continue as a going concern involves making a judgement about inherently uncertain future outcomes of events or conditions.

What are relevant factors to that judgement?

Ans. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Q-37 While conducting the audit of Amrit Ltd. the auditor A of ABC and Associates, Chartered Accountants observes that there are a large number of trade receivables standing in the books of account as on 31st March. The auditor wanted to send confirmation request to a few large trade receivables but the management refused the auditor to send confirmation request. How would the auditor proceed?

Ans. In the given case of Amrit Ltd, the auditor wanted to send confirmation request to a few large trade receivables but the management did not want the auditor to send confirmation request.

If the management refuses to allow the auditor to send a confirmation request , the auditor shall-

1. Inquire as to management's reasons for the refusal and seek audit evidence as to their validity and reasonableness.
2. 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
3. Perform alternative audit procedures designed to obtain relevant and reliable evidences.
4. 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 evidences from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260.

The auditor shall also determine the implication for the audit and the auditor's opinion in accordance with SA 705.

Q-38 A new team member of GSR & Co., the auditors of Esteem Limited, was of the view that Audit Documentation would not serve any purpose at any stage of Audit. Explain.

Ans. The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

From the above, it can be concluded that Audit documentation serves a number of purposes and hence it would be incorrect to say that audit documentation would not serve any purpose at any stage of audit.

Q-39 While documenting the nature, timing and extent of audit procedures performed in case of audit of PQR Ltd, explain the important matters its auditor should record.

Ans. In documenting the nature, timing and extent of audit procedures performed, the auditor of PQR Ltd shall record:

(i) The identifying characteristics of the specific items or matters tested.

(ii) Who performed the audit work and the date such work was completed; and

(iii) Who reviewed the audit work performed and the date and extent of such review.

Q-40 When information to be used as audit evidence has been prepared using the work of a management's expert and having regard to the significance of expert's work for the auditor's purposes, explain the considerations auditor would consider for the purposes of his audit.

Ans. 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:

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

(ii) Obtain an understanding of the work of that expert; and

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

Q-41 When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor has determined that management of XYZ Ltd has already performed a preliminary assessment of the entity's ability to continue as a going concern. Explain how would auditor of XYZ Ltd proceed in the above case.

Also explain how would the auditor proceed if such an assessment has not yet been performed by the management.

Ans. When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

(i) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(ii) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

Q-42 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. Explain. Also discuss the objectives of an auditor regarding Going concern as per relevant standard on auditing.

Ans. 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

(i) intends to liquidate the entity or to cease operations,

(ii) or has no realistic alternative but to do so.

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 realize its assets and discharge its liabilities in the normal course of business.

The objectives of the auditor regarding Going Concern are:

(1) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

(2) To conclude, based on the audit evidence obtained, whether 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; and

(3) To report in accordance with this SA.

Q-43 As described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Explain stating the auditor's responsibilities with regard to going concern.

Ans. The auditor's responsibilities are:

(1) to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and

(2) to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Q-44 While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time.

In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence.

Ans. **Inquiry: As per SA 500 Audit Evidence: -**

(i) Inquiry consists of seeking information of knowledgeable persons, financial and non - financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

(ii) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

(iii) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

(iv) In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

Q-45 GPS & Co, Chartered Accountants, conducting the audit of Pratibha Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GPS & Co wanted to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GPS & Co with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.

Ans. The auditors, GPS & Co wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

(i) Sales, transfers and charges between segments, and elimination of intersegment amounts.

(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Q-46 Pachranga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose.

Ans. The auditor SPV & Co. shall design and perform audit procedures in order to identify litigation and claims involving the entity (Pachranga International Ltd) which may give rise to a risk of material misstatement, including:

(i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel.

(ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(iii) Reviewing legal expense accounts.

Q-47 TRS & Associates, Chartered Accountants, having completed the audit of Genuine Leathers Ltd has started the assembling of final audit file. TRS & Associates has established policies and procedures for the timely completion of the assembly of audit files.

Explain the various aspects related to final audit file discussed in SA 230 giving specific reference to SQC 1, wherever required.

Ans. The auditor TRS & Associates, Chartered Accountants 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.

(i) SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.

(ii) 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.

(iii) Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

(i) Deleting or discarding superseded documentation.

(ii) Sorting, collating and cross-referencing working papers.

(iii) Signing off on completion checklists relating to the file assembly process.

(iv) Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

(v) 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.

(vi) SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Q-48 State with reasons whether the following statements are correct or incorrect.

1. When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management.
2. While auditing the books of accounts of ABC Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as "Inspection".

Ans. 1. **Incorrect**: When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

2. **Incorrect:** The audit procedure used by the auditor of ABC Ltd. is known as "observation". Whereas inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

Q-49 CA K is re-appointed as the auditor of B Ltd. He wants to re-confirm certain matters and has asked the management to give written representations for the same. Under what circumstances can an auditor ask the management to reconfirm its acknowledgement and understanding of responsibilities in written representation?

Ans. Other Written Representation: Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor, CA K of B Ltd, may also ask management of B Ltd to reconfirm its acknowledgement and understanding of those responsibilities in written representations.

This is particularly appropriate when:

(i) Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;

(ii) The terms of the audit engagement were prepared in a previous year;

(iii) There is any indication that management misunderstands those responsibilities; or

(iv) Changes in circumstances make it appropriate to do so.

Q-50 Statutory Auditors of TRB Ltd. observed various instances when either the TDS required to be deducted has not been deducted or deducted at lower than prescribed rates resulting in non-compliance of Income Tax provisions. Besides this, non-compliance under other acts like Labour Laws was also noticed by the auditor. What type of policies and procedures will you implement to assist in prevention and detection of non-compliance with laws and regulations?

Ans. Types of polices and procedures to assist prevention and detection of noncompliance with laws & regulation:

The following are examples of the types of policies and procedures, TRB Ltd may implement to assist in the prevention and detection of non-compliance with laws and regulations:

(i) Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.

(ii) Instituting and operating appropriate systems of internal control.

(iii) Developing, publicizing and following a code of conduct.

(iv) Ensuring employees are properly trained and understand the code of conduct.

(v) Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.

(vi) Engaging legal advisors to assist in monitoring legal requirements.

(vi) Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

Q-51 CA K audited the books of accounts of E Ltd. for the financial year 2020-2021. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor and its reliability.

Ans. **Audit Procedure:**

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

In view of above, it can be concluded that CA K used Inspection as an audit procedure.

Q-52 Discuss: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence.

Ans. Reliability of Audit Evidence: As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.

While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

(i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

(ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

(iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

(iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Q-53 The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement.

Ans. The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities take so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.

- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

Q-54 Examine with reasons (in short) whether the following statements are correct or incorrect :

R Ltd. has asked for email responses for the purpose of external confirmation. The auditor, however, feels that external confirmation received electronically involves the risk of its reliability.

Ans. **Correct**: SA 505, "External Confirmations", responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. Hence R Ltd. Should avoid using email responses as evidence for external confirmation.

Q-55 External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. Apart from confirmations for bank balances and accounts receivables, what are the other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement?

Ans. Other examples of situations where external confirmations may be used include the following:

- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms
- Long outstanding share application money.

Q-56 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. Explain. Also discuss the objectives of an auditor regarding Going concern as per relevant standard on auditing**.**

Ans. 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

(i) intends to liquidate the entity or to cease operations,

(ii) or has no realistic alternative but to do so.

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 realize its assets and discharge its liabilities in the normal course of business.

The objectives of the auditor regarding Going Concern are:

(1) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

(2) To conclude, based on the audit evidence obtained, whether 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; and

(3) To report in accordance with this SA.

Q-57 There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain.

Ans. No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is correct :

(a) The auditor shall assemble the audit documentation in an audit file and complete the administrativeprocess of assembling the final audit file on a timely basis after the date of the auditor's report.

(b) The auditor shall assemble the audit documentation in an audit file and shall not complete theadministrative process of assembling the final audit file.

(c) The auditor shall assemble the audit documentation in an audit file and complete the administrativeprocess of assembling the final audit file on a timely basis before the date of the auditor's report.

(d) The auditor shall not assemble the audit documentation in an audit file.

2. Standard on Quality Control (SQC) 1 provides that,

(a) unless otherwise specified by law or regulation, audit documentation is the property of the management.

(b) unless otherwise specified by law or regulation, audit documentation is the property of thosecharged with governance.

(c) unless otherwise specified by law or regulation, audit documentation is the property of themanagement or those charged with governance.

(d) unless otherwise specified by law or regulation, audit documentation is the property of the auditor.

3. Audit evidence includes

(a) information contained in the accounting records underlying the financial statements

(b) both information contained in the accounting records underlying the financial statements and otherinformation.

(c) other information.

(d) information contained in the accounting records underlying the financial statements or otherinformation.

4. Audit evidence is necessary to support the auditor's opinion and report. It is_____in nature and is primarily obtained from audit procedures performed during the course of the audit.

(a) cumulative (b) regressive (c) selective (d) objective

5. Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; or evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

(b) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

(c) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor

(d) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

6. Which of the following is not an example of audit documentation:

(a) Audit programmes (b) Summaries of significant matters

(c) Audit file (d) Checklists.

7. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement -

(a) at the financial statement levels only.

(b) at the assertion levels only.

(c) at the financial statement and assertion levels.

(d) at the financial statement or assertion levels.

8. which of the following is incorrect :

(a) Inquiry consists of seeking information of unknown persons, both financial and non- financial, within the entity or outside the entity.

(b) Inquiry is used extensively throughout the audit in addition to other audit procedures.

(c) Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

(d) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.

9. Which of the following is incorrect :

(a) Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.

(b) Similar to responses to inquiries, written representations are audit evidence.

(c) Written representations are requested from those responsible for the preparation and presentation of the financial statements.

(d) Written representations provide necessary audit evidence and also they provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

10. With reference to SA 300, the auditor shall document:

(a) The overall audit strategy (b) The audit plan

(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

(d) All of the above

11. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment.

(c) Inquire how management intends to address the matter in the financial statements.

(d) All of the above

12. Risk of material misstatement may be defined as the risk

(a) that the financial statements are materially misstated after audit.

(b) that the financial statements are materially misstated during audit.

(c) that the financial statements are materially misstated prior to audit.

(d) All of the above

13. It was observed by auditors that, out of total rice physically counted on 31st March, 2020 about 67 quintals of rice belonged to M/s PQR, a proprietary concern which had sent paddy to this company's plant for extraction of rice. What would be treatment of this item in financial statements of company?

(a) The value of 67 quintals rice would be reflected in company's financial statements as per method of valuation adopted by the company.

(b) The value of 67 quintals rice would be reflected in company's financial statements as per method of valuation adopted by the proprietary concern.

(c) The value of 67 quintals rice would not be reflected in company's financial statements.

(d) The value of 67 quintals rice would be reflected in proprietary concern's financial statements as per method of valuation adopted by the company.

14. Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; or evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

(b) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

(c) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor

(d) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

15. Audit evidence includes

(a) information contained in the accounting records underlying the financial statements

(b) both information contained in the accounting records underlying the financial statements and other information.

(c) other information.

(d) information contained in the accounting records underlying the financial statements information.

16. Which of the following is not an example of an event or condition that may cast significant doubt on entity's ability to continue as a going concern:

(a) Loss of key management without replacement

(b) Adverse key financial ratios

(c) Inability to pay creditors on due date

(d) Current year profit turns to loss after providing depreciation

Case Scenario 1

Roop & Co. are the auditors of Onda group of Hotels. This is the first time the firm is auditing an industry in food and beverages and it is day one of the audit. The engagement partner along with his team wants to make a thorough understanding of the entity and its environment in order to identify and assess the risks of material misstatements, whether due to fraud or error. The following are some of the points identified by them on Day 1.

1. The hotel has two banquet halls. The documentation available for verification of banquet hall revenue is only the invoice raised by the hotel and some mail conversations on customer enquiry and finalization of price. In audit trail, it is found that finance approval of the transaction is only after invoice is sent to them for accounting at final settlement. Advance paid by the clients are not vetted through finance team.

   The auditor suspects a weakness in this system.

2. The auditor also finds a control deficiency in the process of procurement of stores. A goods receipt note is not prepared at the time of receipt of goods. On enquiry with management, the auditor finds that there exists a system control wherein goods receipt note is automatically prepared and approved in the system once the quantity and price of goods is entered against specific vendor. This entry is on real -time basis and system does not allow back dated entries.

3. The auditor enquires of the management as to what is risk assessment process followed by the entity for prevention and detection of risk of material misstatement due to fraud and error. The auditor finds there is no documented risk assessment process.

With the help of the above facts, answer the following questions by choosing the correct option.

1. In the context of SA 315, which among the following is **NOT** a risk assessment procedure?

(a) Inquiries of management, of appropriate individuals within internal audit function and of others within the entity

(b) Analytical Procedures

(c) Observation and Inspection

(d) Audit Planning.

2. What should be the course of action of the auditor for the entity not having a documented risk assessment process?

(a) The auditor should obtain management written representations on how risks are identified

(b) The auditor shall discuss with management on how risks are identified, addressed and determine whether the absence is appropriate in the circumstances or whether it represents a significant deficiency in internal control.

(c) The auditor should advise the management to document the same immediately and accordingly opine on the same in his audit report too.

(d) The auditor shall discuss with management on how risks are identified by system and place reliance on the same as documentation in this context is immaterial.

3. Which of the following is not an example of an event or condition that may cast significant doubt on entity's ability to continue as a going concern:

(a) Loss of key management without replacement

(b) Adverse key financial ratios

(c) Inability to pay creditors on due date

(d) Current year profit turns to loss after providing depreciation

Case Scenario-2

M/s JJ & associates having office in Chennai are statutory auditors under Companies Act, 2013 of a company viz. Sweet Aroma Private Limited engaged in business of obtaining and manufacturing rice from paddy catering to both domestic as well as international market mainly in Gulf nations. The company has a huge plant capacity for rice extraction in one of the states in Northern India. Needless to state that inventories are in huge quantity in such type of business consisting of raw material, work in progress and finished goods. The auditors want to obtain sufficient appropriate audit evidence regarding inventories.

In above context, answer the following questions: -

1. Which of the following is most likely correct in relation to obtaining of sufficient appropriate audit evidence regarding existence and condition of inventory?

(a) It is mandatory for the auditor to attend physical inventory counting on the date of financial statements in all circumstances.

(b) Physical inventory counting may be attended by auditor on the date of financial statement or at a date other than date of financial statements in his discretion mandatorily in all circumstances.

(c) The attendance of auditors at physical inventory counting is impracticable due to time and costs involved because of auditor's office location vis -a-vis company's plant location. Hence, attendance at physical inventory counting may be skipped and alternative audit procedures may be performed to obtain sufficient appropriate evidence.

(d) The auditor shall attend at physical inventory counting unless impracticable.

However, issue of time and costs involved because of auditor's office location vis-avis company's plant location is not a valid basis for skipping physical inventory counting.

2. Below are given certain cluster of matters which are relevant in planning attendance of auditor at physical inventory counting. Which of the following clusters consists of a likely inappropriate combination?

(a) Nature of inventory, timing of physical inventory counting and stages of completion of work in progress

(b) Nature of inventory, timing of physical inventory counting and valuation method of inventory

(c) Nature of inventory, timing of physical inventory counting, considerations regarding maintenance of a perpetual inventory system

(d) Risks of material misstatements related to inventory, nature of internal control pertaining to inventory, considerations regarding maintenance of a perpetual inventory system.

3. Which of the following is the most likely logical sequence of steps in relation to attendance at physical inventory counting by auditor?

(a) Observance of performance of management's count procedures, inspection of inventory, performing test counts and evaluation of management's procedures for recording and controlling results of physical inventory counting

(b) Observance of performance of management's count procedures, performing test counts, inspection of inventory and evaluation of management's procedures for recording and controlling results of physical inventory counting

(c) Performing test counts, inspection of inventory, Observance of performance of management's count procedures and evaluation of management's procedures for recording and controlling results of physical inventory counting

(d) Evaluation of management's procedures for recording and controlling results of physical inventory counting, Observance of performance of management's count procedures, inspection of inventory and performing test counts.

4. During attendance at physical inventory counting, the auditor inspects inventory. Following outcomes stated as I, II & III are given below of this inspection procedure: -

Outcome I --- Existence of inventory

Outcome II ---- Ownership of inventory

Outcome III ------ Condition of inventory

Which of following statements is most likely true?

(a) Outcomes I, II and III are all necessarily established after inspection.

(b) Only Outcomes I and III are established after inspection and Outcome II is never established.

(c) Outcomes I and III are established after inspection. However, outcome II may not be necessarily established.

(d) Outcome II and III are established after inspection. However, outcome I may not be necessarily established.

❑

NOTES

CHAPTER-4

RISK ASSESSMENT AND INTERNAL CONTROL

Q-1 In performing an audit of financial statements, the auditor should have or obtain knowledge of thebusiness. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment".

Ans. **Obtaining Knowledge of the Business:** The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

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 following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

(b) The nature of the entity, including:
   - (i) its operations;
   - (ii) its ownership and governance structures;
   - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   - (iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting polic ies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Q-2 The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

Advise what is included in control environment. Also explain the elements of control environment.

Ans. **Control Environment – Component of Internal Control:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriatefoundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management.

(iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) **Commitment to competence** – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) **Participation by those charged with governance –** Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) **Management's philosophy and operating style –** Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) **Organisational structure –** The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) **Assignment of authority and responsibility -** Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Q-3 ABC Ltd is engaged in manufacturing of different type of yarns. On going through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor.

Ans. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling theresults of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Q-4 The assessment of risks is a matter of professional judgment. Explain stating clearly what is not included in Audit Risk?

Ans. **Assessment of Risks - Matter of Professional Judgement**

The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

What is not included in Audit Risk ?

(i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

(ii) Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Q-5 Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. Analyse and Explain.

Ans. **While obtaining audit evidence about the effective operation of internal controls,** the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

Q-6 The extent and the nature of the audit programme is substantially influenced by the internal control system in operation. Analyse and explain.

Ans. **The auditor can formulate his entire audit programme only after he has had** a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

Q-7 The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. Explain.

Ans. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

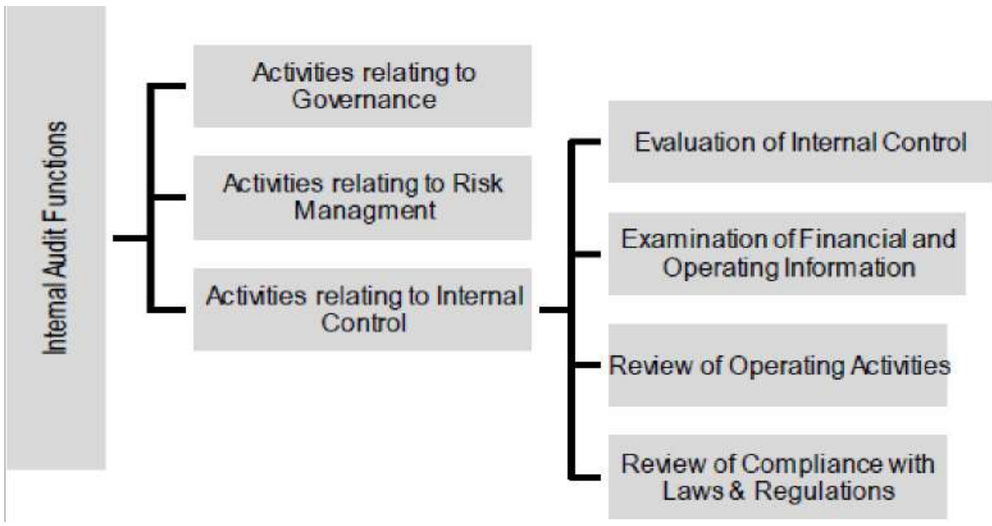
It can be concluded from the above that- **Risk of Material Misstatement= Inherent Risk x Control Risk**

Q-8 Explain the meaning, objectives and scope of internal audit functions as per SA 610**.** Also discuss who can be appointed as Internal Auditor?

Ans. **Who can be appointed as Internal Auditor?** As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

The objectives and scope of internal audit functions: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:



1. **Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.
2. **Activities Relating to Risk Management:** The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.
3. **Activities Relating to Internal Control**
   - **(i) Evaluation of internal control.** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
   - **(ii) Examination of financial and operating information.** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

(vi) Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Q-9 IT poses specific risks to an entity's internal control. Explain

Ans. **IT also poses specific risks to an entity's internal control, including, for example:**

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

Q-10 The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyse and explain.

Ans. **Satisfactory Control Environment - not an absolute deterrent to fraud:** The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Q-11 So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. Explain stating clearly the benefits of evaluation of internal control to the auditor.

Ans. **So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme.** The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

(i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(ii) whether an adequate internal control system is in use and operating as planned by the management;

(iii) whether an effective internal auditing department is operating;

(iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);

(v) whether the controls adequately safeguard the assets;

(vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

(vii) how reliable the reports, records and the certificates to the management can be;

(viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

(ix) what would be appropriate audit technique and the audit procedure in the given circumstances;

(x) what are the areas where control is weak and where it is excessive; and

(xi) whether some worthwhile suggestions can be given to improve the control system.

Q-12 A Flow Chart is a graphic presentation of each part of the company's system of internal control. Explain elaborating each and every aspect about flow chart.

Ans. **A Flow Chart:** It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

Q-13 The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. Analyse and explain.

Ans. **The auditor can formulate his entire audit programme only after he has had** a satisfactory understanding of the internal control systems and their actual operation.

If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programme. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed. From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

Q-14 Auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143. Explain stating clearly the auditor's responsibility for reporting on internal financial controls over financial reporting.

Ans. **Auditors' Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India**

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Objectives of an auditor in an audit of internal financial controls over financial **reporting: The** auditor's objective in an audit of internal financial controls over financial reporting is, "to express an opinion on the effectiveness of the company's internal financial controls over financial reporting." It is carried out along with an audit of the financial statements.

Reporting under Section 143(3)(i) is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

Q-15 As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, state the factors which shall be considered by the auditor.

Explain the above in context of SA-315.

Ans. Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following-

(i) Whether the risk is a risk of fraud;

(ii) Whether the risk is related to recent significant economic, accounting or otherdevelopments like changes in regulatory environment etc. and therefore requiresspecific attention;

(iii) The complexity of transactions;

(iv) Whether the risk involves significant transactions with related parties;

(v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Q-16 Discuss what is included in risk assessment procedures to obtain audit evidenceabout the design and implementation of relevant controls.

Ans. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Q-17 "P India" Ltd. is a manufacturer of various sports products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims, which may give rise to risk of material misstatements. Suggest the audit procedures in the given case.

Ans. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(iii) Reviewing legal expense accounts.

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.

Q-18 "A multinational co. wants to appoint you to carry the statutory audit." Discuss with reference to SA 330 the substantive procedures to be performed to assess the risk of material misstatement.

Ans. **Substantive procedures to be performed to assess the risk of material misstatement:** Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:

   (i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and

(ii) there are inherent limitations to internal control, including management override.

2. Depending on the circumstances, the auditor may determine that:
   - Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
   - Only tests of details are appropriate.
   - A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.
4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

Q-19 Name the assertions for the following audit procedures:

(i) Year end inventory verification.

(ii) Depreciation has been properly charged on all assets.

(iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.

(iv) All liabilities are properly recorded in the financial statements.

(v) Related party transactions are shown properly.

Ans. (i) Year end inventory verification: Existence Assertion.

(ii) Depreciation has been properly charged on all assets: Valuation Assertion.

(iii) Title deed of lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.

(iv) All liabilities are properly recorded in the financial statements: Completeness.

(v) Related party transactions are shown properly: Presentation & Disclosure.

Q-20 What constitutes a 'true and fair' view, is the matter of an auditor's judgement in the particular circumstances of a case. In order to ensure 'true and fair' view, auditor has to review certain points. Mention any such 5 (five) points in brief.

Ans. **True and Fair View:** 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 profit and loss account and balance sheet discloses all the matters required to be disclosed;

(vi) accounting policies have been followed consistently; and

(vii) all unusual, exceptional or non-recurring items have been disclosed separately.

Q-21 Briefly discuss the limitations of Internal Control.

Ans. **Limitations of Internal Control:**

(i) **Internal control can provide only reasonable assurance**: Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) **Human judgment in decision-making:** Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

(iii) Lack of understanding the purpose: Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) **Collusion among People:** Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) **Judgements by Management:** Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) **Limitations in case of Small Entities:** Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Q-22 XYZ & Associates, Chartered Accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences.

Ans. **Evaluating the Operating Effectiveness of Controls:** When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

(a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Q-23(a) When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain.

(b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples.

Ans.(a) Control risk assessment when control deficiencies are identified: When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

(b) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320;
- Considering the appropriateness of the selection and application of accounting policies;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

Q-24(a) Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

(b) It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales.

Ans.(a) Objectives of Internal Control

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are :

(i) transactions are executed in accordance with managements general or specific authorization;

(ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets are safeguarded from unauthorised access, use or disposition; and

(iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

(b) It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

Q-25 Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting.

Ans. **In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:**

i. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

ii. The risks arising from the characteristics of the control, including whether it is manual or automated;

iii. The effectiveness of general IT-controls;

iv. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control;

v. Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

vi. The risks of material misstatement and the extent of reliance on the control.

Q-26 The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control.

Ans. **Division of Internal Control into Components:** The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(i) The control environment;

(ii) The entity's risk assessment process;

(iii) Monitoring of controls.

(iv) Control activities; and

(v) The information system, including the related business processes, relevant to financial reporting, and communication;

Q-27 The risks of material misstatement may exist at the financial statement level and assertion level. Explain the two levels.

Ans. **Risks of Material Misstatement at Two levels**

The risks of material misstatement may exist at two levels:

(i) The overall financial statement level- Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially a ffect many assertions.

(ii) The assertion level for classes of transactions, account balances, and disclosures-Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

Q-29 For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points.

Ans. For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Q-30 Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

Explain with the help of examples.

Ans. **Inquiries of Management and Others Within the Entity:** Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with di fferent levels of authority.

Examples

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, postsales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity¡¦s marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

Q-31 Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail.

Ans. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Q-32 When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement.

Ans. **Correct :** When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Q-33 Briefly discuss the limitations of Internal Control.

Ans. **Limitations of Internal Control:**

(i) **Internal control can provide only reasonable assurance:** Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) **Human judgment in decision-making:** Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

(iii) **Lack of understanding the purpose:** Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) **Collusion among People:** Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) **Judgements by Management:** Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) **Limitations in case of Small Entities:** Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Q-34 One of the directors of Very Fresh Fruits Limited was of the opinion that internal auditor to be appointed must be an employee of Very Fresh Fruits Limited.

Ans. **Incorrect:** As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

Q-35 Explain the meaning of internal financial controls as per the Companies Act, 2013. Also explain its objectives.

Ans. **Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as,** "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

From the above definition, it is clear that **internal financial controls are** the policies and procedures adopted by the company for:

1. ensuring the orderly and efficient conduct of its business, including adherence to company's policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information."

Q-36 The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control.

Ans. **Division of Internal Control into Components:** The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(i) The control environment;

(ii) The entity's risk assessment process;

(iii) Monitoring of controls.

(iv) Control activities; and

(v) The information system, including the related business processes, relevant to financial reporting, and communication;

Q-37 As per Section 138 of the Companies Act, 2013 only listed companies are required to appoint an internal auditor.

Ans. **Applicability of Provisions of Internal Audit:** As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in rule 13 of Companies(Accounts) Rules,2014) shall be required to appoint an internal auditor (which may be either an individual or a partnership firm or a body corporate), namely-

(1) every listed company;

(2) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(3) every private company having-

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In view of above, it would not be correct to state that only Listed Companies are required to appoint an internal auditor.

Q-38 Care Ltd. is an unlisted public limited company, During the financial year 2019-20, the paid-up share capital of Care Ltd. was INR 50 crore and the turnover was INR 80 crore. During the financial year 2020-21, the Board of Directors of the company appointed an internal auditor. Whether Care Ltd. is required to appoint an internal auditor according to the provisions of the Companies act, 2013?

Ans. **As per section 138 of the Companies Act, 2013**: following class of companies (prescribed in rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely-

(a) every listed company;

(b) every unlisted public company having-

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year.

Conclusion: Applying the above to the given problem, since Care Ltd is an unlisted public company and having paid up share capital of ‘ 50 crores during the preceding F.Y. 2019-20, therefore, Care Ltd is required to appoint an Internal Auditor.

Q-39 Explain how Internal Financial Control and Internal controls over financial reporting differ?

Ans. Difference between internal financial control and internal control over financial reporting **Internal Financial Control as per Section 134(5)(e),** “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

On the other hand, Internal controls over financial reporting-is required where auditors are required to express an opinion on the effectiveness of an entity’s **internal controls over financial reporting**, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

Q-40 Discuss the objectives and scope of internal audit functions with respect to activities relating to internal control.

Ans. The objectives and scope of internal audit functions **relating to Internal Control are:**

(i) **Evaluation of internal control:** The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(ii) Examination of financial and operating information: The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(ii) Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

(iv) Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Q-41 What factors are to be considered by an auditor while making control risk assessments?

Ans. Auditor assesses control risk as Rely or Not rely on Controls. When making control risk assessments, the factors an auditor would consider are:

- The control environment's influence over internal control. A control environment that supports the prevention, detection and correction of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity.
- Evaluations of the related IT processes that support application and IT-dependent manual controls.
- Our testing approach over SCOTs and disclosure processes (i.e., controls reliance or substantive only strategy).
- The expectation of the operating effectiveness of controls based on the understanding.

Q-42 Auditor GR and Associates have been appointed to conduct audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditors do not think that it would be necessary to understand internal controls. Advise the auditor in this regard explaining clearly the benefits of understanding the internal control.

Ans. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Benefits of Understanding the Internal Control

An understanding of internal control assists the auditor in:

(i) identifying types of potential misstatements;

(ii) identifying factors that affect the risks of material misstatement, and

(iii) designing the nature, timing, and extent of further audit procedures.

Q-43 Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, the significance of the related risk etc. Explain in detail.

Ans. **Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:**

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

Q-44 The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard.

Ans. **The auditor shall obtain an understanding of the information system, including** the related business processes, relevant to financial reporting, including the following are as:

(a) The classes of transactions in the entity's operations that are significant to the financial statements;

(b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;

(d) How the information system captures events and conditions that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity's financial statements;

(f) Controls surrounding journal entries.

Q-45 The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. Explain in detail stating clearly the meaning of control activities and also discuss control activities that are relevant to the audit.

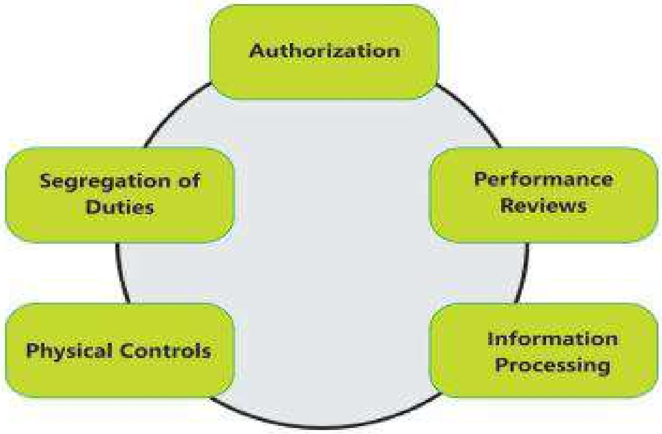
Ans. The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement.

An audit requires an understanding of **only those control activities** related to **significant class of transactions, account balance, and disclosure** in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.

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

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Examples of specific control activities include those relating to the following:



Control activities that are relevant to the audit are:

- Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
- Those that are considered to be relevant in the judgment of the auditor;
- As part of the risk assessment, the auditor shall determine whether any of the **risks identified are, in the auditor's judgment, a significant risk.**

Q-46 Generally, IT benefits an entity's internal control by enabling an entity to enhance the timeliness, availability, and accuracy of information. Discuss explaining the other relevant points in the above context.

Ans. **Generally, IT benefits an entity's internal control by enabling an entity to:**

(i) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;

(ii) Enhance the timeliness, availability, and accuracy of information;

(iii) Facilitate the additional analysis of information;

(iv) Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;

(v) Reduce the risk that controls will be circumvented; and

(vi) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Q-47 While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk.

Ans. Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Q-48 Saburi Textile Ltd is an established player in the textile manufacturing sector. It has developed strong internal controls in almost every area. It has appointed you as an Internal Audit team head. Internal audit has a very strong relation with internal control of the company. Internal Audit analyses the effectiveness with which the internal control of the company is operating and also makes suggestions for improvement in that internal control.

Explain stating clearly activities relating to Internal Control.

Ans. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the activities Relating to Internal Control:

(i) Evaluation of internal control: The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(ii) Examination of financial and operating information: The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.

(vi) Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Internal audit has a very strong relation with internal control of a company. Internal Audit analyzes the effectiveness with which the internal control of a company is operating and also makes suggestions for improvement in that internal control.

Q-49 State with reasons whether the following statements are correct or incorrect.

Internal control cannot eliminate risk of material misstatements in the financial statements.

Ans. **Correct:** Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management. However, internal control can only reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

There is possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

Q-50 Auditor or Sunshine Ltd. is of the view that due to greater management intervention to specify accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is the view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions.

Ans. **Risk of Material Misstatement – Greater for Significant Non-Routine Transactions:**

Significant risks often relate to significant non- routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

Risks of Material Misstatement– Greater for Significant Non-Routine Transactions Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

(a) Greater management intervention to specify the accounting treatment.

(b) Greater manual intervention for data collection and processing.

(c) Complex calculations or accounting principles.

(d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Keeping in view above, view of Auditor of Sunshine Ltd is correct.

Q-51 Examine with reasons (in short) whether the following statements are correct or incorrect :

1. Inquiry alone ordinarily does not provide sufficient audit evidence.
2. The SAs do not ordinarily refer to inherent risk and control risk separately.

Ans. 1. **Correct**: Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

2. **Correct:** The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non - quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

Q-52 Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, size of the entity etc.

Explain the other relevant considerations in the above context.

Ans. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organisation and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

Q-53 Examine with reasons (in short) whether the following statements are correct or incorrect :

1. Control environment can prevent, detect and correct a material misstatement.
2. There is an inverse relationship between detection risks and the combined level of inherent and control risks.

Ans. 1. Incorrect: The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

2. Correct: There is an inverse relationship between detection risks and the combined level of inherent and control risks. For example, when inherent and control risks are high. acceptable detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risks and still reduce audit risks to an acceptably low level.

Q-54 The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc.

Explain the other considerations in this regard.

Ans. **The auditor shall obtain an understanding of the information system, including the related** business processes, relevant to financial reporting, including the following are as under:

(a) The classes of transactions in the entity's operations that are significant to the financial statements;

(b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;

(d) How the information system captures events and conditions that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity's financial statements;

(f) Controls surrounding journal entries.

MULTIPLE CHOICE QUESTIONS

1. A difference between the amount, classification, presentation, or disclosure of a reported financialstatement item and the amount, classification, presentation, or disclosure that is required for the item tobe in accordance with the applicable financial reporting framework is :

(a) Misstatement (b) Error (c) fraud (d) Any

2. The assessment of the risks of material misstatement may be expressed in

(a) quantitative terms, such as in percentages, or in non-quantitative terms.

(b) quantitative terms, such as in percentages.

(c) non-quantitative terms.

(d) None of the above

3. SA 315 establishes requirements and provides guidance on identifying and assessing the risks ofmaterial misstatement -

(a) at the financial statement levels only.

(b) at the assertion levels only.

(c) at the financial statement and assertion levels

(d) at the financial statement or assertion levels.

4. The risks of material misstatement at the assertion level consist of two components:

(a) Inherent risk and detection risk (b) control risk and detection risk

(c) audit risk and detection risk **(d) Inherent risk and control risk**

5. Audit risk is a function of the

(a) risks of material misstatement and detection risk.

(b) audit risk and detection risk.

(c) control risk and detection risk.

(d) inherent risk and detection risk.

6. ____________refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

(a) Misstatement (b) Error (c) Fraud (d) Any of the above

7. A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request is-

(a) Positive confirmation request (b) Non-response

(c) Exception **(d) Negative confirmation request**

8. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel.

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.

(c) Reviewing legal expense accounts.

(d) All of the above

9. One of your junior audit team members is confused with the term 'material misstatement'. You explain him that a material misstatement is untrue information in a financial statement that could affect the financial decisions of one who relies on the statement. Which of the following would constitute material misstatement?

(1) An error of ₹ 5,000 in relation to assets of ₹ 20 lakhs.

(2) A payroll fraud of ₹ 100 in a company where profit before tax is ₹ 11,000.

(3) Non-disclosure of a material uncertainty.

(4) Financial statements have been prepared on a going concern basis when the company is in the process of being liquidated.

(a) 1 and 2 **(b) 3 and 4** (c) 2 and 3 (d) 1 and 4

10. ______refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

(a) Audit assessment procedures (b) substantive procedures

(c) test of control **(d) Risk assessment procedures**

11. When more persuasive audit evidence is needed regarding the effectiveness of a control,

(a) it may be appropriate to increase the extent of testing of the control and reduce the extent of the degree of reliance on controls.

(b) it may be appropriate to decrease the extent of testing of the control as well as the degree of reliance on controls.

(c) it may be appropriate to decrease the extent of testing of the control and increase the extent of the degree of reliance on controls.

(d) it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls.

12. When deviations from controls upon which the auditor intends to rely are detected,

(a) the auditor shall not make any inquiries to understand these matters and their potential consequences

(b) the auditor shall make specific inquiries to understand these matters and their potential consequences

(c) the auditor shall make general inquiries to understand these matters and their potential consequences

(d) the auditor shall make both general as well as specific inquiries to understand these matters and their potential consequences

13. A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered is called-

(a) Negative confirmation request **(b) Non-response**

(c) Exception (d) Positive confirmation request

14. Coyote Ltd. is dealing in trading of electronic goods. Huge inventory (60% approximately) of the company is lying on consignment (i.e. under the custody of third party). CA. Star, the auditor of the company, wants to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory lying on consignment. Thus, he requested & obtained confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity, however, it raised doubts about the integrity and objectivity of the third party. Which of the following other audit procedures may be performed by CA. Star to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory under the custody of third party?

(a) Attend third party’s physical counting of inventory.

(b) Arrange for another auditor to attend third party’s physical counting of inventory.

(c) Inspect warehouse receipts regarding inventory held by third parties.

(d) All of the above.

15. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under applicable law or regulation;

(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

(c) Withdraw from the audit engagement where possible under applicable law or regulation and determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

(d) Withdraw from the audit engagement where possible under applicable law or regulation or determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

16. Risk of material misstatement may be defined as the risk

(a) that the financial statements are materially misstated after audit.

(b) that the financial statements are materially misstated during audit.

(c) that the financial statements are materially misstated prior to audit.

(d) All of the above

Case Scenario 1

Roop & Co. are the auditors of Onda group of Hotels. This is the first time the firm is auditing an industry in food and beverages and it is day one of the audit. The engagement partner along with his team wants to make a thorough understanding of the entity and its environment in order to identify and assess the risks of material misstatements, whether due to fraud or error. The following are some of the points identified by them on Day 1.

1. The hotel has two banquet halls. The documentation available for verification of banquet hall revenue is only the invoice raised by the hotel and some mail conversations on customer enquiry and finalization of price. In audit trail, it is found that finance approval of the transaction is only after invoice is sent to them for accounting at final settlement. Advance paid by the clients are not vetted through finance team.

   The auditor suspects a weakness in this system.

2. The auditor also finds a control deficiency in the process of procurement of stores. A goods receipt note is not prepared at the time of receipt of goods. On enquiry with management, the auditor finds that there exists a system control wherein goods receipt note is automatically prepared and approved in the system once the quantity and price of goods is entered against specific vendor. This entry is on real -time basis and system does not allow back dated entries.

3. The auditor enquires of the management as to what is risk assessment process followed by the entity for prevention and detection of risk of material misstatement due to fraud and error. The auditor finds there is no documented risk assessment process.

With the help of the above facts, answer the following questions by choosing the correct option.

1. What kind of a risk is portrayed in the booking of revenue with respect to Banquet halls?

(a) Inherent risk in the class of transaction

(b) Control risk in the class of transaction

(c) Detection risk in the audit procedures

(d) Audit risk in the opinion on the financial statements.

Case Scenario 2

Roop & Co. are the auditors of Onda group of Hotels. This is the first time the firm is auditing an industry in food and beverages and it is day one of the audit. The engagement partner along with his team wants to make a thorough understanding of the entity and its environment in order to identify and assess the risks of material misstatements, whether due to fraud or error. The following are some of the points identified by them on Day 1.

1. The hotel has two banquet halls. The documentation available for verification of banquet hall revenue is only the invoice raised by the hotel and some mail conversations on customer enquiry and finalization of price. In audit trail, it is found that finance approval of the transaction is only after invoice is sent to them for accounting at final settlement. Advance paid by the clients are not vetted through finance team.

   The auditor suspects a weakness in this system.

2. The auditor also finds a control deficiency in the process of procurement of stores. A goods receipt note is not prepared at the time of receipt of goods. On enquiry with management, the auditor finds that there exists a system control wherein goods receipt note is automatically prepared and approved in the system once the quantity and price of goods is entered against specific vendor. This entry is on real -time basis and system does not allow back dated entries.

3. The auditor enquires of the management as to what is risk assessment process followed by the entity for prevention and detection of risk of material misstatement due to fraud and error. The auditor finds there is no documented risk assessment process.

With the help of the above facts, answer the following questions by choosing the correct option.

1. Which among the following statement is **incorrect** in the context of Audit Risk?

   (a) The more extensive the audit procedures performed, the lower is the detection risk

   (b) Greater the risk of material misstatement the auditor believes exist, less is the detection risk that can be accepted and accordingly more persuasive evidence is required by the auditor.

   (c) Audit risk means the risk that the auditor gives an appropriate audit opinion when the financial statement are materially misstated.

   (d) Risk of material misstatement at the assertion level is of two kinds – control risk and inherent risk.

2. In the case of procurement of stores, the auditor has tested more than one control for the same assertion.

   In that given case, what should be his reliance on the control?

   (a) Since compensating controls are identified, if tested and evaluated to be effective, the auditor can rely on the control.

   (b) Even though compensating controls are there, since one control is ineffective, the auditor should not rely on control for this assertion and should perform extensive procedures.

   (c) Documentation in electronic medium cannot be accepted, hence, he cannot rely only on s ystem control.

   (d) Even though compensating controls are there, since one control is ineffective, the auditor should not rely on control for this assertion as well as associated assertions.

❑

CHAPTER-5
FRAUD AND RESPONSIBILITIES OF THE AUDITOR IN THIS REGARD

Q-1 "Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users." Discuss.

Ans. **Fraudulent Financial Reporting:** Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting.

In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Fraudulent financial reporting may be accomplished by the following:

(i) Manipulation, falsification (including forgery), or alteration of accounting records or supportingdocumentation from which the financial statements are prepared.

(ii) Misrepresentation in or intentional omission from, the financial statements of events,transactions or other significant information.

(iii) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

Q-2 Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. Explain with examples.

Ans. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act. For example:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome.
- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control. Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Q-3 Write the circumstances that indicate the possibility of fraud due to problematic or unusual relationship between the auditor and management.

Ans. Problematic or unusual relationships between the auditor and management, including:

1. Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
2. Undue time pressures imposed by management to resolve complex or contentious issues.
3. Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
4. Unusual delays by the entity in providing requested information.
5. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
6. Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
7. An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
8. An unwillingness to address identified deficiencies in internal control on a timely basis.
9. Unwillingness by management to permit the auditor to meet privately with those charged with governance
10. Accounting Policy that appears to be variance with industry norms
11. Frequent changes in accounting estimates that do not appear to result from changed circumstances
12. Tolerance of variations in the entity's code of conduct

Q-4 The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains anunderstanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

Advise what is included in control environment. Also explain the elements of control environment.

Ans. Control Environment – Component of Internal Control: The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management.

(iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) **Commitment to competence** – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) **Participation by those charged with governance –** Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) **Management's philosophy and operating style** – Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) **Organisational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Q-5 The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. Explain.

Ans. **Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]:** The auditor is also required to report under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Audit Procedures and Reporting under CARO:

(1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

(2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

(3) The auditor should obtain written representations from management that:

(i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(iii) it has

(a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(b) disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

(4) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud. (5)Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

(i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

(iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

Q-6 Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence. Explain stating clearly how this type of fraud is generally committed.

Ans. **Manipulation of Accounts:** Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

(a) to avoid incidence of income-tax or other taxes;

(b) for declaring a dividend when there are insufficient profits;

(c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and

(d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Q-7 Explain how would you deal as an auditor if, as a result of a misstatement resulting from fraud or suspected fraud, you encounter exceptional circumstances that bring into question your ability to continue performing the audit.

Ans. **If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:**

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

  (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

  (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

  (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

  (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

  (c) If the auditor withdraws:

    (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

    (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Q-8 Discuss the different ways in which defalcation of cash may take place.

Ans. **Defalcation of Cash:** Defalcation of cash has been found to perpetrate generally in the following ways:

(a) **By inflating cash payments.** Examples of inflation of payments:

(1) Making payments against fictitious vouchers.

(2) Making payments against vouchers, the amounts whereof have been inflated.

(3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.

(4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) **By suppressing cash receipts.** Few techniques of how receipts are suppressed are:

(1) Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) By casting wrong totals in the cash book.

Q-9 Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways. Analyse and Explain.

Ans. **Misappropriation of Assets:** It involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

Fig.: Theft of Assets*

- Embezzling receipts (for example, misappropriatingcollections on accounts receivable or divertingreceipts in respect of written-off accounts to personalbank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

  Example : Vineet is a manager in Zed Ex Ltd. He is having authority to sign cheques up to ₹10,000. While performing the audit, Rajan, the auditor, noticed that there were many cheques of ₹9,999 which had been signed by Vineet. Further Vineet had split large payments (amounting to more than ₹10,000 each, into two or more cheques less than ₹10,000 each so that he may authorize the payments). This raised suspicion in the auditor.

  The auditor found that the cheques of ₹9,999 were deposited in Vineet's personal account i.e. Vineet had misappropriated the amount.

  Splitting the cheques into lower amounts involves manipulation of accounts.

  The fraud was committed by an employee.
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

  Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Q-10 The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. Explain

Ans. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Q-11 Saburi Yarns Ltd is engaged in manufacturing and trading of yarns of different types. Its huge amount is locked up in account receivables. Moreover, Management of Saburi Yarns Ltd is worried about its Internal Control system over receipts from account receivables and other receipts. Management wants to understand from you as an auditor few techniques as to how receipts can be suppressed resulting into frauds and finally incurring losses.

Ans. **Few Techniques of how receipts are suppressed are:**

(1) Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, *e.g.,* sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

Q-12 Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Explain.

Ans. The Standard on Auditing (SA) 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as-

"an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements.

Two types of intentional misstatements are relevant to the auditor–

- misstatements resulting from fraudulent financial reporting and
- misstatements resulting from misappropriation of assets.

Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

Q-13 Write any five circumstances of conflicting or missing evidence that indicate the possibility of fraud.

Ans. **Conflicting or missing evidence, including:**

(i) Missing documents.

(ii) Documents that appear to have been altered.

(iii) Significant unexplained items on reconciliations.

(iv) Unusual discrepancies between the entity's records and confirmation replies.

(v) Large numbers of credit entries and other adjustments made to accounts receivable records.

(vi) Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.

(vii) Missing inventory or physical assets of significant magnitude.

(viii) Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.

Q-14 Mr. A is appointed as statutory auditor of a company for the Financial Year ended 31st March, 2018. During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2018. The fraud was going on since last 2-3 years and the total amount misappropriated exceeding ₹ 100 lakhs. As a statutory auditor, what would be reporting responsibilities of Mr. A?

Ans. **Reporting to the Central Government-** As per **section 143(12)** of the Companies Act, 2013 read with **Rule 13** of the Companies (Audit and Auditors) Rules, 2014, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as prescribed.

The manner of reporting the matter to the Central Government is as follows:

(1) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(2) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(3) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(4) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(5) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(6) the report shall be in the form of a statement as specified in Form ADT-4.

The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 [CARO, 2016], whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

Q-15 Discrepancies in the accounting records, including transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy is one of the example of circumstances that indicate the possibility of fraud. Explain at least four other such examples relating to discrepancies in the accounting records.

Ans. Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Q-16 "If an accounting professional, whether in the course of internal or external audit or in the processof institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smells any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action". Analyse and explain the above RBI Circular regarding liability of accounting and auditing profession.

Ans. The RBI issued a Circular relating to implementation of recommendations of Committee on Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under: "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render h imself liable for action". As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI. Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". The said Standard explains that the duty of confidentiality is over-ridden by statute, law or by courts. SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements " states that an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/ Managing Director/Chief Executive of the concerned bank.

Duty to report on Frauds under the Companies Act, 2013 - As per sub-section 12 of section 143 of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

Q-17 "Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets." State any three examples of such occurrence of misappropriation of such assets.

Ans. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) Inadequate segregation of duties or independent checks.

(ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements

(iii) Inadequate record keeping with respect to assets.

(iv) Inadequate system of authorization and approval of transactions (for example, in purchasing).

(v) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

(vi) Lack of complete and timely reconciliations of assets.

(vii) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.

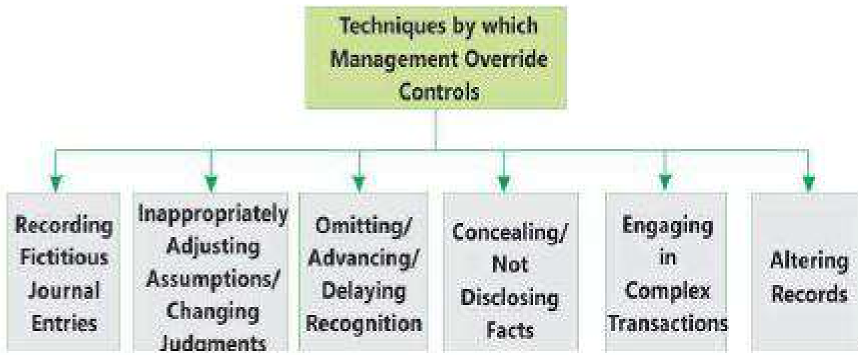
(viii) Lack of mandatory vacations for employees performing key control functions.

(ix) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.

(x) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Q-18 Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Explain the techniques used to commit fraud by management overriding controls.

Ans. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:



- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

Q-19 Explain what an auditor is expected to do if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit.

Ans. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Q-20 As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ₹ 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government. Explain the manner of reporting the matter to the Central Government in the above context.

Ans. The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

Q-21 Fraud in the form of misappropriation of goods is still more difficult to detect. Explain.

Ans. Fraud in the form of misappropriation of goods is still more difficult to detect; for this, management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationery. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists.

Q-22 Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence. Explain stating the objective behind committing such fraud.

Ans. Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed:

(a) to avoid incidence of income-tax or other taxes;

(b) for declaring a dividend when there are insufficient profits;

(c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and

(d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Q-23 List out any three circumstances which induce the management/ employee to commit the fraud.

Ans. Circumstances which induce the management/ employee to commit fraud are :

- Financial obligations/ Pressure.
- Management's unrealistic goals.
- Dissatisfied Employees or Lack of motivation among employees.
- Name game (eg. management using power of authority by asking employees to do something illegal).
- Opportunity to commit fraud.

Q-24 "Theft of an entity's assets is often perpetrated by employees in relatively small and immaterial amounts." Explain the various ways in which the same can be accomplished?

Ans. Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including :

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Q-25 As an Auditor of XYZ Bank Limited, how would you assess the Risk of Fraud including Money Laundering in line with SA 240 ?

Ans. As an Auditor of XYZ Bank Limited, risk of fraud including money laundering would be assessed as explained hereunder which is in line with SA 240.

As per **SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"**, the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.

The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and “Know Your Customer (KYC)” norms. The RBI has from time to time issued guidelines (“Know Your Customer Guidelines – Anti Money Laundering Standards”), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

Q-26 Explain any three ways where cash receipts are suppressed.

Ans. Few techniques of how receipts are suppressed are:

(1) **Teeming and Lading:** Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer’ accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, *e.g.,* sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

Q-27 As an auditor of PQR Ltd., you came across a misstatement resulting from fraud or suspected fraud which brings into question your ability to continue performing the audit.

Explain the courses of actions available to you.

Ans. In the given case of PQR Ltd, the auditor came across a misstatement resulting from fraud or suspected fraud that brought into question the auditor’s ability to continue performing the audit. In such a situation, the auditor shall :

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

  (i) Discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal.

  (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s withdrawal from the engagement and the reasons for the withdrawal.

Q-28 Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also report under clause (x) of paragraph 3 of Companies (Auditor’s Report) Order, 2016, the nature of fraud and amount involved. Explain the considerations an auditor would keep in mind for reporting under this clause.

Ans. Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016, the nature of fraud and amount involved.

For reporting under this clause, the auditor may consider the following:

(i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

(iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

Q-29 The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. Explain.

Ans. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance.

In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Q-30 CA Dev of D R Sanduja & Co., statutory auditor of company, Girija Fabs Ltd, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud to the tune of Rs 1.25 Crores has been committed in the company by its employees. CA Dev, the auditor wanted to report the matter to the Central Government as per Law. He refers to Rule 13 of the Companies (Audit and Auditors) Rules, 2014. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ' **1 crore or above**, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

In the above context, explain the manner of reporting the matter to the Central Government.

Ans. The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

Q-31 While conducting audit of Always Best Company Ltd, auditor B of B L Kapur & Co. observes lot of intentional misstatements, e.g. fake invoices etc., and considers these encounters as exceptional circumstances and this brings into question his ability to continue performing the audit. Advise B as to what should he do?

Ans. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Q-32 State with reasons whether the following statements are correct or incorrect.

Reporting of fraud of INR 150 Lakhs by auditor will be done within three days of the fraud coming to the knowledge of the auditor to the Board or the Audit Committee along with remedial action taken.

Ans. **Incorrect**: The auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days. Company is bound to disclose remedial action taken in Board's report.

Q-33 Examine with reasons (in short) whether the following statements are correct or incorrect :

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type

Ans. **Correct:** Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that, if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way.

Q-34 Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. Explain giving examples.

Ans. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) Inadequate segregation of duties or independent checks.

(ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements

(iii) Inadequate record keeping with respect to assets.

(iv) Inadequate system of authorization and approval of transactions (for example, in purchasing).

(v) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

(vi) Lack of complete and timely reconciliations of assets.

(vii) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.

(viii) Lack of mandatory vacations for employees performing key control functions.

(ix) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.

(x) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Q-35 Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

Illustrate any three techniques by which fraud can be committed by management overriding controls.

Ans. Techniques of fraud committed by Management: Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

(1) Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives

(2) Inappropriately adjusting assumptions and changing judgments used to estimate account balances

(3) Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period

(4) Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements

(5) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity

(6) Altering records and terms related to significant and unusual transactions.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is an example of inflating cash payments?

(a) Making payments against purchase vouchers.

(b) Teeming and lading.

(c) Not accounting for cash sales fully.

(d) Making payments against inflated vouchers.

2. In case of a fraud involving less than ₹ 1 crore, the auditor shall

(a) report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.

(b) report the matter to the audit committee constituted under section 177 within such time and in such manner as prescribed.

(c) report the matter to the Board within such time and in such manner as prescribed.

(d) report the matter to the audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed.

3. If, as a result of a misstatement resulting from fraud, the auditor encounters exceptional circumstances that bring into question his ability to continue performing the audit, he shall-

(a) Withdraw from the engagement immediately.

(b) Report to Audit team regarding withdrawal.

(c) Determine the professional and legal responsibilities applicable in the circumstances.

(d) Ask the management for his withdrawal.

4. M/s PQR & Associates is appointed as the new auditors of M/s Prince Ltd. On conducting the audit, the firm found that the accountant has entered fake invoices of credit purchases in the books of accounts aggregated of ₹ 75 Lakhs and cleared all the payments to the fake creditor.

The auditor M/s PQR & Associates should report such fraud to :

(a) Central Government (b) Reserve Bank of India

(c) Board of Directors/Audit Committee (d) Comptroller & Auditor General

Case Scenario 1

<u>Integrated case study</u>

Mr. Laxman is appointed as statutory auditor of Best Limited for the Financial Year ended 31st March, 2020. During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2020.

The fraud was going on since last 4-5 years and the total amount misappropriated is approximately ₹ 75 lacs. Balance sheet of Best Ltd. reflected a cash balance of ₹ 7 crores. The company has taken a loan of ₹ 2 crores from the bank despite of the huge cash balance with the company.

Also, Companies Act bestows some duties on auditors to report matters to Central Government in case of fraud.

On the basis of above facts answer below questions in relation to Mr . Laxman's role and duties while conducting statutory audit of Best Limited.

1. Mr. Laxman suspects that cash payments were inflated. Out of the below which could be probable reason for such inflated cash payments.

(a) Not accounting for cash sales completely

(b) Making payments against purchase vouchers

(c) Making payments against inflated vouchers

(d) Teeming and Lading

❑

CHAPTER-6
AUDIT IN AN AUTOMATED ENVIRONMENT

Q-1 Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.Explain stating the points that an auditor should consider to obtain an understanding of the company's automated environment.

Ans. **Understanding and Documenting Automated Environment:** Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment.

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

Q-2 The fundamental principle of an automated environment is the ability to carry out business with less manual intervention. Explain.

Ans. The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

For example, if a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

Q-3 In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. Explain stating uses of Data analytics.

Ans. **In today's digital age when companies rely on more and more on IT systems and networks** to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil".

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following,

- check completeness of data and population that is used in either test of controls or substantive audit tests
- selection of audit samples – random sampling, systematic sampling
- re-computation of balances – reconstruction of trial balance from transaction data
- reperformance of mathematical calculations – depreciation, bank interest calculation.
- analysis of journal entries as required by SA 240
- fraud investigation
- evaluating impact of control deficiencies

Q-4 Discuss the different ways testing is performed in an automated environment.

Ans. The following are different ways testing is performed in an automated environment :

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, Inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application

Q-5 Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should consider the risks that arise from the use of IT systems. Explain.

Ans. Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems.

Given below are some such risks that should be considered,

- Inaccurate processing of data, processing inaccurate data, or both
- Unauthorized access to data
- Direct data changes (backend changes)
- Excessive access / Privileged access (super users)
- Lack of adequate segregation of duties
- Unauthorized changes to systems or programs
- Failure to make necessary changes to systems or programs
- Loss of data

Q-6 Explain the meaning of automated environment. Also discuss the key features of an automated environment.

Ans. **An automated environment basically refers to a business environment** where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business. For example, think about how banking transactions are carried out using ATMs (Automated T eller Machines), or how tickets can be purchased using "apps" on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day. Some of the key features of an automated environment are as follows:

Key features of an Automated Environment

- Enables faster business operations
- Accuracy in data processing and computation
- Ability to process large volumes of transactions
- Integration between business operations
- Better security and controls
- Less prone to human errors
- Provides latest information
- Connectivity and Networking capability

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

For example, if a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

Q-7 Discuss the situations in which IT will be relevant to an audit.

Ans. **Given below are some situations in which IT will be relevant to and audit,**

- Increased use of Systems and Application software in Business (for example, use of ERPs)

- Complexity of transactions has increased (multiple systems, network of systems)
- Hi-tech nature of business (Telecom, e-Commerce)
- Volume of transactions are high (Insurance, Banking, Railways ticketing)
- Company Policy (Compliance)
- Regulatory requirements - Companies Act 2013 IFC, IT Act 2008
- Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE
- Increases efficiency and effectiveness of audit

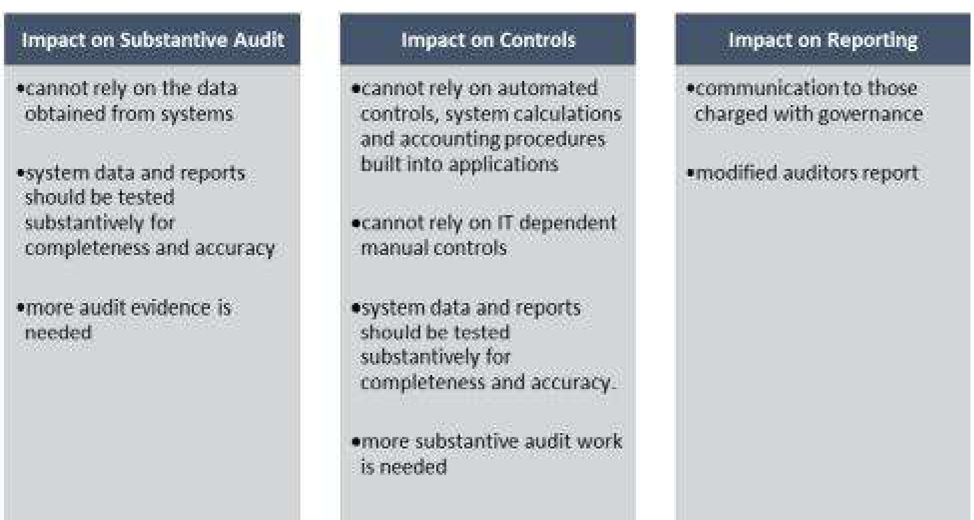
Q-8 When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems. Explain stating the points that an auditor should consider to substantiate the above.

Ans. **When a business operates in a more automated environment** it is likely that we will see several business functions and activities happening within the systems. Consider the following aspects,

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation)
- Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic)
- Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically)
- Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report)
- User access and security are controlled by assigning system roles to users (**for example,** segregation of duties can be enforced effectively)

Q-9 Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting.

Ans. **Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting:** The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:



- First, we may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.

- Second, we will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.
- Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

  In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work. The auditor should also be able to demonstrate how the risks were identified and what audit evidence was obtained and validated to address these IT risks.

  Here, we should remember that as the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly. The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately.

Q-10 With respect to audit in an automated environment, explain the following:

(i) CAATs (ii) Data Analytics (iii) Database (iv) Information Systems

(v) Privileged access

Ans.(i) CAATs: Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.

(ii) Data Analytics: A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information

(iii) Database: A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.

(iv) Information Systems: Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.

(v) Privileged access: A type of super user access to information systems that enforces less or no limits on using that system.

Q-11 List any five points that an auditor should consider to obtain an understanding of the Company's automated environment.

Ans. **Understanding of the Company's Automated Environment:** Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

Q-12 Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform Fraud investigation.

Explain the other relevant points in the above context i.e. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform.

Ans. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- Check completeness of data and population that is used in either test of controls or substantive audit tests.

- Selection of audit samples – random sampling, systematic sampling.
- Re-computation of balances – reconstruction of trial balance from transaction data.
- Reperformance of mathematical calculations – depreciation, bank interest calculation.
- Analysis of journal entries as required by SA 240.
- Fraud investigation.
- Evaluating impact of control deficiencies.

Q-13 With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. Explain stating clearly the meaning of Automated environment with example.

Ans. With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. In this context, it is critical to understand the IT specific risks that could potentially impact the integrity and reliability of financial transactions and data flowing through a company's systems.

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems - also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

Example

Think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using "apps" on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

Q-14 When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. Explain which of the aspect you will consider relevant as an auditor.

Ans. When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. As an auditor, there is a need to consider the following aspects :

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
- Accounting entries are posted automatically (for example, sub -ledger to GL postings are automatic).
- Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
- User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Q-15 Describe how risks in IT systems, if not mitigated, could have an impact on audit.

Ans. When risks in IT systems are not mitigated the audit impact could be as follows:

(i) The auditor may not be able rely on the reports, data obtained, automated controls, calculations and accounting procedures in the IT system.

(ii) The auditor has to perform additional audit work by spending more time and efforts.

(iii) The auditor may have to issue a modified opinion, if necessary.

Q-16 List any five points that an auditor should consider to obtain an understanding of the Company's automated environment.

Ans. **Understanding of the Company's Automated Environment:** Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

Q-17 Foreceful Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2020-21, the company transferred its accounts from manual to computerized system (SAP). PQR & Co., Chartered Accountants have specialization in the system audit and have been appointed as the system auditor. PQR & Co., at the end of the audit concludes that there are certain findings or exceptions in IT environment and IT controls of the company which needs to be assessed and reported. Mention those points of consideration.

Ans. At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal Controls Memo or Management Letter.
- Communicate in writing any significant deficiencies to Those Charged With Governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

Q-18 Discuss the common methods applied by the auditor when testing in an automated environment is done by him.

Ans. There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods.

Inquiry alone is not sufficient.

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry,observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application.
- Inspect the system logs to determine any changes made since last audit testing.
- Inspect technical manual / user manual of systems and applications.
- Carry out a test check (negative testing) and observe the error message displayed by the application.
- Conduct reperformance using raw source data and independently applying formulae,
- business rules or validations on the source data using CAATs.

Q-19 While it is true that companies can benefit immensely from the use of data analysis in terms of increased profitability, better customer service, etc., analyse various functions that can be performed even by the auditor also using Data Analytics tools and techniques in the audit process to obtain good results.

Ans. In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil".

The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

Data analytics can be used in testing of electronic records and data residing in IT systemsusing spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- Check completeness of data and population that isused in either test of controls or substantive audit tests. Selection of audit samples – random sampling, systematic sampling.
- Re-computation of balances – reconstruction of trial balance from transaction data. Re performance of mathematical calculations – depreciation, bank interest calculation.
- Analysis of journal entries as required by SA240, Fraud investigation and Evaluating impact of control deficiencies.6.

Q-20 Analyse how risks in the IT system if not mitigated could have an impact on the audit.

Ans. When risks in IT systems are not mitigated, the audit impact could be as follows:

(i) First, we may not be able to rely on the reports, data obtained from systems where such risk exist. This means all forms of data, information or reports that we obtains from system for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.

(ii) Second, we will not be able to rely on automated controls, calculations and accounting procedures that are built into the application. Additional audit work may be required in this case.

(iii) Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

Q-21 Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Discuss the activities performed by Data Center and Network operations. Also explain the meaning of General IT Controls in detail. **[RTP-May'21]**

Ans. "General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the **integrity** of information and **security of data** commonly include controls over the following:"

(i) Data center and network operations

(ii) Program change

(iii) Access security

(iv) Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls. Let us now learn about each of the General IT controls in more detail.

Data Center and Network Operations

Objective: To ensure that production systems are processed to meet financial reporting objectives.

Activities:

1. Overall Management of Computer Operations Activities
2. Batch jobs – preparing, scheduling and executing
3. Backups – monitoring, storage & retention
4. Performance Monitoring – operating system, database and networks
5. Recovery from Failures – BCP, DRP
6. Help Desk Functions – recording, monitoring & tracking
7. Service Level Agreements – monitoring & compliance
8. Documentation – operations manuals, service reports

Q-22 Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the selection of audit samples. Explain giving other relevant points also in the above context of data analytics.

Ans. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

- Check completeness of data and population that is used in either test of controls or substantive audit tests.
- Selection of audit samples ¡V random sampling, systematic sampling.
- Re-computation of balances ¡V reconstruction of trial balance from transaction data.
- Reperformance of mathematical calculations ¡V depreciation, bank interest calculation.
- Analysis of journal entries as required by SA 240.
- Fraud investigation.
- **Evaluating impact of control deficiencies.**

Q-23 With respect to audit in an automated environment, explain the following:

(i) Applications
(ii) Automated
(iii) CAATs
(iv) Data Processing
(v) General (IT) Controls

Ans.(i) Applications: These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format.

(ii) Automated: A task or activity that is routinely performed by a computer system and does not require manual effort

(iii) CAATs: Short form for Computer Assisted Audit Techniques, are a collection of computer-based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.

(iv) Data Processing: Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

(v) General (IT) Controls: Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.

Q-24 Explain the meaning of Internal Financial Controls clearly stating reporting requirement (with reference to audit) on adequacy of internal financial controls. Also discuss about its (reporting requirement on adequacy of internal financial controls) applicability on various types of Companies.

Ans. Explanation given in Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

From the above definition, it is clear that internal financial controls are the policies and procedures adopted by the company for:

1. ensuring the orderly and efficient conduct of its business, including adherence to company's policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information."

Section 143(3)(i) of the Act requires an auditor to report whether the company has adequate internal financial controls **with reference to financial statements** in place and the operating effectiveness of such controls.

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–

(i) One person company; or

(ii) Small company; or

(iii) Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than ₹ 25 crore.

Q-25 When a business operates in a more automated environment, we are likely to see several business functions and activities happening within the systems. List down the business functions and activities happening within the systems.

Ans. Relevance of Information Technology in an Audit:

When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems. Consider the following aspects instead of:

(i) Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).

(ii) Accounting entries are posted automatically (for example, sub-ledger to GL postings is automatic).

(iii) Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).

(iv) Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).

(v) User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Q-26 Examine with reasons (in short) whether the following statements are correct or incorrect :

1. All automated environments are not complex.
2. A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as meaningful data.

Ans. 1. Correct: The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.

2. **Incorrect** A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as Data Analytics.

Q-27 Explain some of the points that an auditor should consider to obtain an understanding of the company's automated environment.

Ans. **Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:**

- Information systems being used (one or more application systems and what they are).
- Their purpose (financial and non-financial).
- Location of IT systems - local vs global.
- Architecture (desktop based, client-server, web application, cloud based).
- Version (functions and risks could vary in different versions of same application).
- Interfaces within systems (in case multiple systems exist).
- In-house vs Packaged.
- Outsourced activities (IT maintenance and support).
- Key persons (CIO, CISO, Administrators).

The understanding of a company's IT environment that is obtained should be documented.

Q-28 When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. Explain which of the aspect you will consider relevant as an auditor.

Ans. When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. As an auditor, there is a need to consider the following aspects :

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
- Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).
- Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
- User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

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CHAPTER-7
AUDIT SAMPLING

Q-1 XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analysing the whole accounts receivables, auditor wanted to use sampling technique. In considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques. Advise the auditor in accordance with SA 530.

Ans. **Stratification and Value-Weighted Selection:** In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, **for example,** when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, **for example, the accounts receivable balance, the** auditor may then examine the particular items, for example, individual balances, that contain **those monetary units.**

One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

Q-2 The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Explain stating the examples of factors (any four) that the auditor may consider when determining the sample size for tests of controls.

Ans. The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls.The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased).Thus, sample size will increase.
- If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
- When there is an increase in the expected rate of deviation of the population to be tested thensample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
- An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size.

  Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
- In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

Q-3 The auditor shall evaluate the results of the sample and whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. Analyse and explain.

Ans. The auditor shall evaluate-

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Q-4 There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain

Ans. No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

Q-5 The extent of the checking to be undertaken is primarily a matter of judgment of the auditor.

It is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed Explain

Ans. The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.

Q-6 The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement. Explain

Ans. **The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement** but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Q-7 Discuss the factors that should be considered for deciding upon the extent of checking on a sampling plan.

Ans. **The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:**

(i) Size of the organisation under audit.

(ii) State of the internal control.

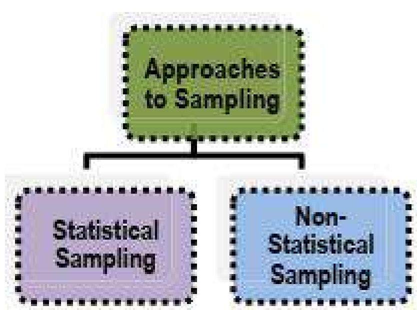
(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

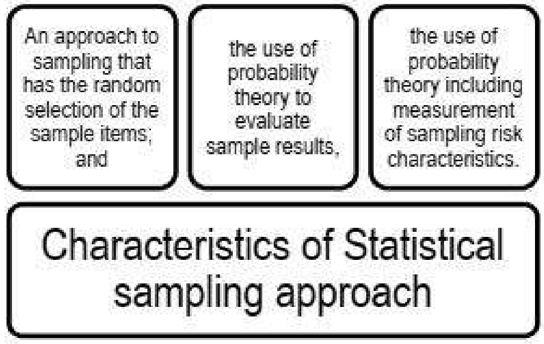
(v) Degree of the desired confidence.

Q-8 Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. Discuss explaining Statistical and Non Statistical sampling approaches.

Ans. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.



Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered **non-statistical sampling**.



The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample must be representative.

Whatever may be the approach non-statistical or statistical sampling, the sample **must be representative.** This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Q-9 Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example.

Ans. **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example

Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

Q-10 Audit testing done through Statistical sampling is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Explain and also state advantages of Statistical sampling.

Ans. Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probabili ty in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

The advantages of statistical sampling may be summarized as follows -

(1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(2) The sample selection is more objective and thereby more defensible.

(3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

(4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

(5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Q-11 Sampling risk is the risk that the auditor's conclusion based on a sample may be di fferent from the conclusion if the entire population were subjected to the same audit procedure.

Sampling risk leads to erroneous conclusions. Explain in detail distinguishing it from nonsampling risk with examples.

Ans. Sampling Risk. The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-Sampling Risk. The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Example

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sources of Non Sampling risk are :

Human Mistakes

Misinterpreting the sample results

Applying audit procedures not appropriate to the objectives of audit

Relying on erroneous information e.g. erroneous confirmation

Non sampling risk can never be mathematically measured.

Q-12 Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan.

Ans. The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

(i) Size of the organisation under audit.

(ii) State of the internal control.

(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

(v) Degree of the desired confidence.

Q-13 While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

Ans. **Risk Factors while applying Sampling Techniques:** As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exists when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatements exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Q-14 CA X is not sure about the kind of Sampling method to be used for audit of a company. Advise him about the choice of methods (name of methods only) of Sampling to be used in various circumstances. Also explain briefly the advantages of the Sampling to be used by him in auditing.

Ans. **Sample Selection:**

CA. X should obtain the knowledge before using the sampling methods. The principal methods are as follows:

(1) Random selection.

(2) Systematic selection.

(3) Monetary Unit sampling.

(4) Haphazard selection.

(5) Block selection.

Advantages of Statistical Sampling in Auditing:

(i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(ii) The sample selection is more objective and thereby more defensible.

(iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

(iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

(v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Q-15 CAB is appointed as an auditor of M/s. Divine Pharmacy, a wholesale medicine supplier. While auditing for the financial year 2020-21, CA B wants to use test checking technique. Advise CA B, what kind of precautions should be taken by him in this regard.

Ans. While auditing the accounts of Divine Pharmacy, CA B wanted to use Test Checking technique. The following Precautions should to be taken by CA B while applying test check techniques:

- Thorough study of accounting system should be done before adopting sampling
- Proper study of internal control systems.

- Areas which are not suitable for sampling should be carefully considered. eg: compliance with statutory provisions, transactions of unusual nature etc.
- Proper planning for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly classified (stratified)
- Sample size should be appropriately determined.
- Sample should be chosen in unbiased way,
- Errors located in the sample should be analyzed properly.

Q-16 It is imperative for the auditor to project misstatements for the population while performing audit procedures through sampling. Comment.

Ans. (i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

(ii) When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

(iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Q-17 Explain the following terms with reference to Audit Sampling :

(i) Stratification (ii) Tolerable misstatement

(iii) Tolerable rate of deviation

Ans.(i) **Stratification –** The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

(ii) **Tolerable misstatement** – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

(iii) **Tolerable rate of deviation** – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Q-18 In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Explain in detail.

Ans. In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organisation because they provide the reliability of the records. Sampling is used as a part of Test of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for test of details (i.e checking of transactions and balances)

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

Q-19 What are the advantages of Statistical sampling technique in auditing

Ans. **Advantages of Statistical Sampling in Auditing: The advantages of statistical sampling may be summarized as follows -**

(i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(ii) The sample selection is more objective and thereby more defensible.

(iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

(iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

(v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Q-20 Sampling risk can lead to two types of erroneous conclusions. Explain clearly stating the meaning of sampling risk

Ans. Sampling Risk. The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

This risk will always be in existence when auditor uses sampling technique in conducting his audit.

Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a **test of controls**, that controls are more effective than they actually are, or in the case of a **test of details,** that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. This is because of over reliance on the internal controls.

(ii) In the case of a **test of controls**, that controls are less effective than they actually are, or in the case of a **test of details,** that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect. This is because of under reliance on the test of controls and detailed substantive procedures performed by the auditor. Here risk of giving wrong opinion is minimum but it will lead to more detailed checking which is time consuming.

Q-21 State with reasons whether the following statements are correct or incorrect.

Statistical sampling being more scientific and without personal bias bias will always be appropriate to use under all circumstances.

Ans. **Incorrect:** Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Q-22 With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider when determining the sample size for the Test of Details –

(i) The desired level of assurance

(ii) Stratification of the pollution.

Ans. **Examples of factors influencing Sample Size for Test of Details:**

(i) Desired Level of Assurance: An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

(ii) Stratification of population: When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

Q-23 ABC Ltd is a Large Company with huge purchase and sales transactions. Which sampling approach is recommended in such a company? Explain giving features of such sampling approach along with example

Ans. **In larger organisations, with huge transactions, statistical sampling is always rec ommended as it is unbiased, and the samples selected are not prejudged.**

Features/Characteristics of Statistical Sampling:

(1) Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.

(2) Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

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

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

Q-24 Examine with reasons (in short) whether the following statements are correct or incorrect :

The level of sampling risk that the auditor is willing to accept will not affect the sample size.

Ans. **Incorrect:** As per SA 530, "Audit Sampling" the level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

MULTIPLE CHOICE QUESTIONS

1. In the case of tests of details

- **(a) the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population.**
- (b) the projected misstatement is the auditor's best estimate of misstatement in the population.
- (c) the anomalous misstatement is the auditor's best estimate of misstatement in the population.
- (d) the projected misstatement plus anomalous misstatement, if any, cannot be the auditor's best estimate of misstatement in the population.

2. Which of the following is correct :

- (a) When the projected misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
- **(b) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.**
- (c) When the anomalous misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
- (d) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample provides a reasonable basis for conclusions about the population that has been tested.

3. It is a type of value-weighted selection in which sample size, selection and evaluation results in aconclusion in monetary amounts :

- (a) Haphazard sampling
- **(b) Monetary Unit Sampling**
- (c) Stratified Sampling
- (d) Interval sampling

❑

NOTES

CHAPTER-8
ANALYTICAL PROCEDURES

Q-1 Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).

Explain stating the techniques available as substantive analytical procedures.

Ans. procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

- **Trend analysis** — A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- **Ratio analysis** — Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.
- **For example, Financial ratios may include:**
- Trade receivables or inventory turnover
- Freight expense as a percentage of sales revenue
- **Reasonableness tests** — Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.
- **Structural modelling** — A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Q-2 Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain.

Ans. **Substantive Analytical Procedure**: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Q-3 The reliability of data is influenced by its source and nature and is dependent on the circumstancesunder which it is obtained. Accordingly, explain the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures.

Ans. The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

Q-4 Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis. Analyse and Explain stating clearly the meaning of analytical procedures.

Ans. Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit.

Meaning of Analytical Procedures. As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Q-5 Give examples of Analytical Procedures having consideration of comparisons of the entity's financial information

Ans. **Examples of Analytical Procedures having consideration of comparisons of the entity's financial information with are:**

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry

Q-6 If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, explain how would the auditor investigate such differences.

Ans. **If analytical procedures performed in accordance with SA 520** identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Q-7 The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities. Analyse and Explain.

Ans. The relationships between individual financial statements items traditionally **considered in** the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

Q-8 Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Explain stating the purpose of analytical procedures with examples.

Ans. **Purpose of Analytical Procedures :** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

(i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year's reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

Example: In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry account receivables and account payables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him. Also whether in the case of account payable, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance. Similarly, by taking inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued. In the same way, by reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected. The overall tests can be extended for making inter-firm and intra-firm comparison of trading results. For example, if balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists. Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. For instance the cost of importing goods which are subjected to an ad valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, *e.g.,* commission paid to a manager calculated on the basis of net profits,commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios,trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Q-9 Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).

Explain stating the techniques available as substantive analytical procedures.

Ans. **Techniques available as substantive analytical procedures:** The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

Trend analysis — A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis — Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

For example, Financial ratios may include:

Trade receivables or inventory turnover

Freight expense as a percentage of sales revenue

Reasonableness tests — Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.

Structural modelling — A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Q-10 Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

Ans. **Trend analysis** – A commonly used technique is the comparison of current data with the prior period **balance** or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Q-11 When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Explain the other relevant points in this context.

Ans. When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

(i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

Q-12 Discuss the audit procedure to be considered by an auditor while performing analytical procedure to obtain audit evidence as to overall reasonableness of purchase quantity and price.

Ans. **Auditor needs to perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:**

(i) **Consumption Analysis:** Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from management if any significant variations found.

(ii) **Stock Composition Analysis:** Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with compare the same with previous years and ask for the reasons from management if any significant variations found.

(iii) **Ratios:** Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.

(iv) Auditor should review **quantitative reconciliation** of closing stocks with opening stock, purchases and consumption.

Q-13 In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain 18. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain.

Ans. In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

Q-14 The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain.

Ans. The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptabl y low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Q-15 If an entity has a known number of employees at fixed rates of pay throughout the period, there would be more need to perform tests of details on the payroll.

Ans. **Incorrect:** If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

Q-16 Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

Ans. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

Q-17 Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances.

Ans. **Analytical Review Procedures:** The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

(i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;

(iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;

(iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

Q-18 The statutory auditor of ABC Ltd., CA Raj identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of ABC Ltd. With reference to SA 520 on "Analytical Procedures", how CA Raj shall investigate such differences?

Ans. If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) **Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:** Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) **Performing other audit procedures as necessary in the circumstances:** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Conclusion: In the present case CA Raj identifies certain inconsistencies while applying analytical procedure to financial or non financial data of ABC Ltd. CA Raj should inquire the management of ABC Ltd, and obtain sufficient and appropriate audit evidences relevant to the management response. Further CA Raj should also perform other audit procedures, if required in the circumstances of the case to obtain further sufficient and appropriate evidence. audit evidences relevant to the management response. Further CA Raj should also perform other audit procedures, if required in the circumstancesof the case to obtain further sufficient and appropriate evidence.

Q-19 Explain the techniques available as Substantive Analytical procedures.

Ans. **Techniques Available as Substantive Analytical Procedures**

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

Trend analysis – A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.

Structural modelling – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Q-20 With respect to SA 520 "Analytical procedures" , explain the following factors to be considered by the auditor for substantive audit procedures.

(i) Account type (ii) Predictability (iii) Nature of Assertion.

Ans. The auditor should consider the following factors for Substantive Audit Procedures:

Account Type – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greatermanagement judgment.

Predictability – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

Nature of Assertion – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/ measurement and occurrence.

Q-21 The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. In this context, discuss the techniques available as Substantive Analytical Procedures.

Ans. **Techniques available as Substantive Analytical Procedures :** The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

Trend analysis — A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis — Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests — Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.

Structural modelling — A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Q-22 Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances.

Ans. **Analytical Review Procedures:** The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

(i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;

(iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;

(iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

Q-23 If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, how would the auditor investigate such differences.

Ans. If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Q-24 Discuss the matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated.

Ans. Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial. For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

Q-25 Whether it is possible to independently verify the correctness of some of the items of expenses included in the statement of profit and loss? Explain with the help of some examples.

Ans. Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty/ GST paid.

Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Q-26 While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

Ans. While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

Trend analysis – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Structural modelling – A modelling tool constructs a statistical model from financial and/or nonfinancial data of prior accounting periods to predict current account balances (e.g., linear regression).

The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depensing upon the availability of data and requirements of the case.

Q-27 Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain

Ans. Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is not an analytical procedure?

(a) Tracing of purchases recurred in the purchase book to purchase invoices

(b) Comparing aggregate wages paid to number of employees

(c) Comparing the actual costs with standard costs

(d) All of them are analytical procedures

2. Which of the following is correct :

(a) different types of analytical procedures provide different levels of assurance.

(b) Different types of analytical procedures provide similar levels of assurance.

(c) Similar type of analytical procedures provide different levels of assurance.

(d) All are correct

3. Which of the following is correct :

(a) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of financial data.

(b) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of non-financial data.

(c) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

(d) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through ratio analysis.

4. Which of the following statement is correct :

(a) Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time

(b) Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time

(c) Substantive analytical procedures are generally more applicable to small volumes of transactions that tend to be predictable over time

(d) None of the above

5. Marvin Ltd. is a renowned food chain supplier in a posh area providing restaurant facility along with food delivering. CA. Felix was appointed as an auditor of the company for the Financial Year 2017-18. While examining the books of account of the company, CA. Felix came to know about one of the major expenses of the company i.e. rent expense of ₹1,20,000 per month, for which he applied substantive analytical procedure for verification purpose. Explain, how would CA. Felix perform substantive analytical procedure in the given scenario?

(a) CA. Felix would inspect every single rent invoice per month of ₹ 1,20,000 and verify other elements appropriately.

(b) CA. Felix would compare the rental expense of the company with that of another nearby company having corresponding dimensions, for high degree of accuracy.

(c) CA. Felix would select the first month rent invoice of ₹ 1,20,000 and appropriately verifying other elements would predict that the rent for the whole year would be ₹ 14,40,000 (i.e. ₹ 1,20,000 * 12). Thereafter, he would compare the actuals with his prediction and follow-up for any fluctuation.

(d) (a) and (b), both.

6. Auditor Compares Gross Profit Ratio with that of Previous year and it is discovered that there has been a fall in the ratio. This is an example of :

(a) Analytical Procedure

(b) Test of Controls

(c) Walk Through Test

(d) Audit Sampling

❑

NOTES

CHAPTER-9

AUDIT OF ITEMS OF FINANCIAL STATEMENTS

Q-1 What are the obvious assertions in the following items appearing in the Financial Statements?

(i) Statement of Profit and Loss

Travelling Expenditure Rs. 50,000

(ii) Balance Sheet

Trade receivable Rs. 2,00,000

Ans. (i) Travelling Expenditure Rs. 50,000

- Expenditure has been actually incurred for the purpose of travelling.
- Travelling has been undertaken during the year under consideration.
- Total amount of expenditure incurred is Rs. 50,000 during the year.
- It has been treated as revenue expenditure and charged to Statement of Profit and Loss.

(ii) Trade receivable Rs. 2,00,000

- These include all sales transaction occurred during the year.
- These have been recorded properly and occurred during the year.
- These constitute assets of the entity.
- These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

Q-2 The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

Ans. In addition to the procedures undertaken for verifying completeness of additions to PPE during th period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties.

Q-3 State assertions that are implied in the extract of financial statement given below:

		(₹)
Plant & Machinery (at Cost)	4,00,000	
Less: Depreciation:		
Up to Previous year	1,40,000	
For the year	26,000	1,66,000
		2,34,000

(i) Indicate assertions in respect of transactions and events for the period relating to Fixed Assets.

(ii) State specific assertions relating to the above extract of financial statement.

Ans.(i) Assertions about transactions and events for the period relating to fixed assets :

(1) Occurrence—transactions and events relating to fixed assets have been recorded, have occurred and pertain to the entity.

(2) Completeness—all transactions and events relating to fixed assets that should have been recorded have been recorded.

(3) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(4) Cut-off—transactions and events have been recorded in the correct accounting period.

(5) Classification—transactions and events have been recorded in the proper accounts.

(ii) The specific assertions are as follows:

(1) the firm owns the plant and machinery;

(2) the historical cost of plant and machinery is Rs. 4 lacs;

(3) the plant and machinery physically exists;

(4) the asset is being utilised in the business of the company productively;

(5) total charge of depreciation on this asset is Rs. 1,66,000 to date on which Rs. 26,000 relates to the year in respect of which the accounts are drawn up; and

(6) the amount of depreciation has been calculated on recognised basis and the calculation is correct

Q-4 Explain with examples the audit procedure to establish the existence of intangible fixed assets as at the period- end.

Ans **Since an Intangible Asset is an identifiable non-monetary asset,** without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion.

Q-5 Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity. Explain stating also criteria for a liability to be classified as current liability.

Ans. **Liabilities in addition to borrowings (discussed above), include** trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity.

Further, a liability is classified as current if it satisfies any of the following criteria:

- It is expected to be settled in the entity's normal operating cycle
- It is held primarily for the purpose of being traded
- It is due to be settled within twelve months after the reporting period
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments does not affect its classification.

Q-6 On going through the financial statements of PQR Ltd, its auditors Kamal Gagan and Associates observed that company has taken Loans from banks and financial institutions. Further, the audit team discusses the following about Liabilities:

"Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include loans/ borrowings, trade payables and other current liabilities, deferred payment credits and provisions.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or over stated, the Balance Sheet would not show a true and fair view of the state of affairs of the company."

Advise stating clearly the audit procedures generally required to be undertaken for verification of existence of Borrowings

Ans. Review board minutes for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are authorized. Ensure that significant debt commitments should be approved by the board of directors

- Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits imposed by agreements are not exceeded.
- Agree overdrafts and loans recorded to bank confirmation / confirmation to lenders.
- Agree details of leases and hire purchase creditors recorded to underlying agreement.
- Examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a discharge is received on assets securing the debt.
- If we become aware of significant transactions that are outside the normal course of business or that otherwise appear to be unusual given our understanding of the entity and its environment, perform the following procedures:

(a) Gain an understanding of the business rationale for such significant unusual transaction.

(b) Consider whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity we are auditing.

Q-7 "Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account."

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure.

Verify to ensure that the system for receivables has the necessary features.

Ans. Trade receivable are an essential part of any organisation's balance sheet. Often referred to as debtors, these are monies which are owed to an organisation by a customer. The most common form of an account receivable is a sale made on credit, via an invoice, to a customer. Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account.

It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. In summary, check to ensure that the system for receivables has the following features:

- Only bona fide sales lead to receivables
- All such sales are to approved customers
- All such sales are recorded
- Once recorded, the debts can only be eliminated by receipt of cash or on the authority of a responsible official
- Debts are collected promptly
- Balances are regularly reviewed and aged, a proper system of follow up exists and if necessary adequate provision for bad debt exists
- Clear segregation of duties relating to identification of debt, receipt of income, reconciliations and write off of debts

Q-8 Liabilities include trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity. Advise stating clearly the audit procedure to establish the existence of trade payables and other current liabilities as at the period-end.

Ans. **Audit Procedure to establish the existence of trade payables and other current liabilities :**

1. Check whether there are controls in place to ensure that the same purchase/ expense invoice cannot be recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense.
2. To ensure that trade payable ledger reconciles to general ledger, ask for a period-end accounts payable aging report and trace the grand total to the amount in the accounts payable account in the general ledger.
3. Calculate the accounts payable report total. Add up the expense/ liability items on the accounts payable aging report to verify that the total traced to the general ledger is correct.
4. Investigate reconciling items. If there are journal entries in the accounts payable account in the general ledger, review the justification for larger amounts. This implies that these journal entries should be fully documented.

Direct confirmation procedures

5. An important audit activity is to contact vendors directly and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit. This should necessarily be done for all significant account payable balances as at the period- end and for parties from whom material purchases have been made during the period under audit even if period- end balance of such parties is not significant.

6. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade payables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

7. The trade creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.

8. The form of requesting confirmation from the trade creditor may be either (a) the 'positive' form of request, wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request wherein the trade creditor is requested to respond only if he disagrees with the balance shown. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the trade creditors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the trade payable balances. In many situations, it may be appropriate to use the positive form for trade creditors with large balances and the negative form for trade creditors with small balances

9. The method of selection of the trade creditors to be circularised should not be revealed to the Company until the trial balance of the trade payables' ledger is handed over to the auditor. A list of trade creditors selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed and auditor should insert an identification mark, example- a team member inserting his initials in the letter (without informing the Company) to enable the auditor to continue to maintain unpredictability in audit and to avoid any wrong doing from management side. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to trade creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

10. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade payables taken as a whole.

11. Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
    - Agreeing the balance to subsequent cash paid;
    - Agreeing the detail of the respective balance to the underlying vendor invoices;
    - Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred;
    - Prepare a final summary of the results of the circularization and draw the final conclusion
12. Related party payables. If there are any related party payables, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
13. Trend analysis. Review a trend line of purchases/ expenses and accounts payable, or a comparison of the two over time, to see if there are any unusual trends. Make inquiries about reasons for changes in trends from the management and document the same in audit work papers.

Q-9 State the matters to be included in the auditor's report as per CARO, 2016 regarding-

(i) Fixed Assets (ii) statutory dues.

Ans. Matters to be included in the Auditor's Report under CARO, 2016: The auditor's report on the accounts of a company to which CARO applies shall include a statement on the following matters, namely-

(i) Fixed Assets -

(1) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

(2) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(3) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof.

(ii) As per clause (vii) of CARO, 2016, reporting requirements in respect of statutory dues are :

(1) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(2) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not be treated as a dispute).

Q-10 Explain the audit procedure to vouch/verify :

(i) Rent expenses (ii) Power and Fuel expenses

Ans.(i) **Rent expense**- Obtain a month wise expense schedule along with the rent agreements. Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement. Specific consideration should be given to escalation clause in the agreement to verify if the rent was to be increased/ adjusted during the period under audit. Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity

(ii) **Power and fuel expense**- Obtain a month wise expense schedule along with the power bills. Verify if expense has been recorded for all 12 months. Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis. In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends

Q-11 Reserves are amounts appropriated out of profits whereas on the contrary, provisions are amounts charged against revenue. Discuss explaining the difference between the two and also explain clearly revenue reserve and capital reserve.

Ans. **Reserves** are amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.

On the contrary, provisions are amounts charged against revenue to provide for:

(i) Renewal or diminution in the value of assets; or

(ii) a known liability, the amount whereof could only be estimated and cannot be deter-mined with accuracy; or

(iii) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in value of assets due to the fact that some of them have been lost or destroyed as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

Difference between Reserves and Provisions

The difference between the two is that provisions are amounts set aside to meet specific/ identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of the fact whether the Company has earned profit or not.

Reserves on the other hand, represent amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.

Examples- to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

Capital Reserve, on the other hand represents a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss

Examples- share premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

Q-12 ABC Ltd. has issued shares for cash at a premium of ₹ 450, that is, at amount in excess of the nominal value of the shares which is ₹ 10 for cash. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

Ans. **Shares Issued at Premium:** In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, anyissue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preferenceshares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above

Q-13 You are an auditor of PQR Ltd. which has spent ₹ 10 lakhs on Research activities of the product during period under audit. Board of Directors want to recognize it as an internally generated intangible assets. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements.

Ans. No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

(i) the said asset is identifiable;

(ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;

(iii) it is probable that future economic benefits associated with the asset will flow to the entity;

(iv) the cost of the item can be measured reliably.

Q-14 While reviewing Employee benefits expenses of a company, how you as an auditor you will evaluate its hiring, appraisal and retirement process?

Ans. While reviewing Employee Benefits expenses auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal and retirement process in the following manner:

(i) The auditor first tests the controls the company has set around the employee benefit payment process to determine how strong and reliable they are. If they are strong, the auditor can minimize the amount of transaction testing he must do. Common internal controls over the employee benefit payment cycle includes maintaining of attendance records, authorisation and approval of monthly payroll processing and disbursement.

(ii) The auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.

(iii) The auditor performs Substantive analytical procedure consisting of monthly expense reasonability, comparison with previous accounting period, any analysis auditor may findrelevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

Q-15 Write the audit procedures to be performed as an auditor for valuation (assertion) of following:

(i) Loans and Advances and other current assets.

(ii) Finished goods and goods for resale.

Ans.(i) Audit procedure for valuation of Loans and Advances and other current assets

- Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.
- Scrutinize the analysis and identify those loans and advances that appear doubtful; Discuss with management their reasons, if any of these loans/ advances are not included in the provision for bad recoverable; Perform further testing where any disputes exist; Reach a final conclusion regarding the adequacy of the bad and doubtful loans/ advances provision.
- Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
- Check that write-offs or other reductions in the recoverable balances have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.
- Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.

(ii) Audit procedure for valuation of finished goods and goods for resale

- Enquire into what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements.

- Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
- Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60- 90 days old, 90- 180 days old, 180- 385 days old and more than 365 days old (refer screenshot below)
- Follow up 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 labor, direct material and overhead have been included.
- Verify the correct application of lower-of-cost-or-net realizable value principles.

Q-16 Expenses which are essentially of a revenue nature if incurred for creating an asset or adding to its value for achieving higher productivity are regarded as expenses of a capital nature. Describe any five such expenses.

Ans. Expenses which are essentially of a Revenue Nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are regarded as expenditure of a capital nature. Examples of capital expenditure are-

(i) Material and wages- capital expenditure when expended on the construction of a building or erection of machinery.

(ii) Legal expenses- capital expenditure when incurred in connection with the purchase of land or building.

(iii) Freight- capital expenditure when incurred in respect of purchase of plant and machinery.

(iv) Repair- Major repairs of a fixed asset that increases its productivity.

(v) Wages- Wages paid on installation costs incurred in Plant & machinery.

(vi) Interest- Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

Q-17 Mention any five attributes to be considered by an auditor while verifying for a depreciation and amortisation expenses.

Ans. **Depreciation and Amortisation Expenses:** Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure that the Company's policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act and applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately has been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

Q-18 As statutory auditor of the company, list out audit procedures required to be undertaken for the following:

(i) Interest income from fixed deposits.

(ii) Dividend income.

(iii) Gain/(loss) on sale of investment in Mutual funds.

Also indicate disclosure requirements of above as per Companies Act, 2013.

Ans.(i) For verifying interest income on fixed deposits:

- Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by multiplying the deposit amount with the applicable rate and number of days during the period under audit.

- For deposits still outstanding as at the period- end, trace the same to the direct confirmation obtained from the respective bank/ financial institution.
- Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
- Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

(ii) **Dividend Income:** For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

(iii) **Gain/(loss) on sale of investment in mutual funds:** Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments. For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.

Disclosure Requirements: Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made:

Whether 'other income'' has been classified as:

- Interest income
- Dividend income
- Other non-operating income (net of expenses directly attributable to such income)

Q-19 Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS). In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards. Explain with example stating the relevant assertions involved in this regard. Also explain financial statement audit.

Ans. Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS).

A financial statement audit comprises the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the financial statements and related disclosures.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards.

Example

If Company X's balance sheet shows building with carrying amount of ' 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).

Q-20 What does the Valuation assertion mean in respect of Assets, liabilities and equity balances? Explain with the help of example in respect of Inventory.

Ans. **Meaning of Valuation Assertion–** Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Example of Inventory explaining the valuation assertion is given hereunder: Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

Q-21 Validity and consequence of issue of shares at discount, check with respect to the provisions of the Companies Act, 2013.

Ans. **Shares issued at discount:**

(i) As per section 53 of the Companies Act, 2013, a company shall not issue share at a discount, except in the case of an issue of sweat equity shares given under section 54 of the Companies Act, 2013. Any share issued by a company at a discounted price shall be void.

(ii) The auditor needs to verify that the company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorising issue of share capital and the issue price.

(iii) Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees: and

(iv) every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees, or with both.

Q-22 Explain the disclosure requirements of IND AS compliant Schedule III to Companies Act, 2013 for each component of "Other Equity."

Ans. **For each component of other equity, whether the company has disclosed the following (to the extent applicable):**

(i) Balance at the beginning of the reporting period

(ii) Changes in accounting policy or prior period error

(iii) Restated balance at the beginning of the reporting period

(iv) Total comprehensive income for the year end

(v) Dividends

(vi) Transfer to retained earnings

(vii) Any other change (to be specified)

(viii) Balance at the end of reporting period

Q-23 Tangible assets are depreciated when the asset is actually put to active use.

Ans. **Incorrect:** Depreciation is a fall in value of asset due to obsolenscene, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use . Active use of asset is not a mandatory criteria for charge of depreciation.

Q-24 You are an auditor of PQR Ltd. which has spent ₹ 50 lakhs on Research activities of the product during period under audit, Board of Directors want to recognize it as an internally generated intangible assets. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements.

Ans. No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

(i) the said asset is identifiable;

(ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;

(iii) it is probable that future economic benefits associated with the asset will flow to the entity;

(iv) the cost of the item can be measured reliably.

Q-25 BNP Ltd has reduced its Share Capital to a greater extent in the year for which you are conducting the audit. State how will you proceed for verifying the reduction of Capital.

Ans. **Reduction of Capital**

For verifying reduction of capital, the auditor needs to undertake the following procedures:

(i) Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;

(ii) Verify that the Articles of Association authorises reduction of capital;

(iii) Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;

(iv) Check the Registrar's Certificate as regards to reduction of capital;

(v) Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;

(vi) Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;

(vii) Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;

(viii) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(ix) Verify that the Memorandum of Association of the company has been suitably amended.

Q-26 How will you vouch/verify the following?

(a) Trademarks and copyrights

(b) Investments income in the case of charitable institutions

(c) Contingent liabilities

(d) Leasehold rights

Ans.(a) Trademarks and Copyrights:

(i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.

(ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trademarks and copyrights have been duly registered.

(iii) Verify existence of copyright by reference to contract between the author & the entity and note down the terms of payment of royalty.

(iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalised.

(v) Ascertain that the legal life of the trademarks and copyrights has not expired.

(vi) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.

(b) Investment Income in the case of Charitable Institution:

(i) Vouching the amounts received with the dividend and interest counterfoils.

(ii) Checking the calculations of interest received on securities bearing fixed rates of interest.

(iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

(iv) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(c) Contingent liabilities:

(i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.

(ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.

(iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.

(iv) Examine bank letters in respect of bills discounted and not matured.

(v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.

(vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.

(vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.

(viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

(d) Leasehold Rights:

(i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument.

(ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.

(iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter .

(v) Ensure that the outlay as well as any legal expenses incurred to acquire the leases which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

Q-27 A significant and important audit activity is to contact banks/ financial institution s directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit.

Explain the audit procedure in this context.

Ans. **Direct confirmation procedure**

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
  - Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;
  - Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Q-28 One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used.

Ans. **Correct:** One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used. Both depreciation and amortization are methods that are used to prorate the cost of a specific type of asset over its useful life. Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life while amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Q-29 The auditor may choose to analyse the monthly trend for Power & Fuel expense. Explain how this analysis will be performed by the auditor

Ans. **Power and fuel expense -**

- Obtain a month wise expense schedule along with the power bills.
- Verify if expense has been recorded for all 12 months.
- Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.
- In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

Q-30 Write the audit Procedure for verification of existence of Trade Receivables.

Ans. For Verification of Existence of Trade Receivables, the auditor should check the following :

i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice.

   Ask for a period-end accounts receivable aging report and trace the balance as per the report to the general ledger.

ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.

iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.

iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.

v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The Com ?

vii. Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:

viii. Agreeing the balance to cash received subsequently;

ix. Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)

x. If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

xi. Check that receivables for other than sales or services are not included in the list.

xii. Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

Q-31 Management of Z Ltd. wants to include all the cost incurred by the Company in valuing the cost of its inventories. The Accountant is, however, of the view that certain costs should be excluded from the cost of inventories and should be recognised as expenses for the period in which they are incurred. What are such costs that should be excluded while determining the cost of inventories?

Ans. **Examples of costs to be excluded in determining cost of Inventory:**

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(i) abnormal amounts of wasted materials, labour, or other production costs;

(ii) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(iii) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(iv) selling and distribution costs.

In the given situation, contention of Z Ltd. is not correct to include all the cost of its inventories while determining the cost of inventory. However, contention of accountant is correct that certain cost should be excluded from the cost of inventories and to be recognised as expenses in period in which they are incurred.

Q-32 While conducting audit of Vee Ltd, CA Aman, auditor of the company, found that some goods are lying with third party for a long period. Advise Aman how will he verify them.

Ans. **Goods Lying with Third Party:** The auditor should check that the materiality of the item under this caption included in inventories.

(i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(ii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(v) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(vii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

(viii) Evaluate condition of goods and see whether adequate provision has been made.

(ix) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(x) Ensure that the goods have been included in the closing inventory though lying with third party.

Q-33 CA "X" while conducting an audit of Joyful Ltd. found a considerable increase in sales as compared to the previous year, he doubts that few fictitious sales have been recorded by the company to overstate its revenues. Discuss any four audit procedures to be undertaken by the auditor to ensure revenue from sales of goods and services performed during the period is not overstated?

Ans. CA X, having doubts about fictitious sales being recorded by Joyful Ltd would ensure that revenue is not overstated by performing following audit procedures:

- Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.
- Test check few invoices with their relevant entries in sales journal.
- Obtain confirmation from few customers to ensure genuineness of sales transaction
- Whether any fictitious customers and sales have been recorded.
- Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
- Whether unearned revenue recorded as earned.
- Whether any substantial uncertainty exists about collectability
- Whether customer obligations are contingent on other actions (financing, resale etc.)

Q-34 The value of intangible assets may diminish due to efflux of time, use and/or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Discuss the audit procedures to be applied by the auditor to ensure that Intangible assets have been valued appropriately and as per generally accepted accounting policies and practices.

Ans. The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts. The auditor should:

- Verify that the entity has charged amortization on all intangible assets;
- Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

  The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any

Q-35 Depreciation and amortisation expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortization expense.

Ans. Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

Q-36 Depreciation and amortisation expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortization expense.

Ans. Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

Q-37 ABC Limited has a closing balance of work in progress of inventories aggregating ' 850 lakhs in their balance sheet as at March 31, 2020.

As Statutory Auditor of ABC Limited, explain various audit procedures which need to be performed to confirm Work-in-progress of inventories have been valued appropriately and as per generally accepted accounting policies and practices.

Ans. Audit procedure which needs to be performed to confirm work in progress worth Rs.850 lakhs has been valued appropriately and as per generally accepted accounting policies and practices is given hereunder:

(1) Ascertain how the various stages of production/ value add are measured and in case estimates are made, understand the basis for such estimates.

(2) Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.

(3) Ensure that material costs exclude any abnormal wastage factors.

Q-38 As a Statutory Auditor of the company list out audit procedure required to be undertaken for the recognition of following other income:

i. Interest income from fixed deposit

ii. Dividend income

iii. Gain/(loss) on sale of investment in mutual funds.

Ans. Statutory auditor would perform the following audit procedure for recognition of different items given in the question:

(1) Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

(2) Dividends are recognised in the statement of profit and loss only when:

(i) the entity's right to receive payment of the dividend is established;

(ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(iii) the amount of the dividend can be measured reliably.

(3) Gain/(loss) on sale of investment in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Q-39 ABC limited appointed XYZ & Company, Chartered Accountants, as a Statutory Auditor of the Company for the year 2019-20. CA X, partner of XYZ & Company, was looking after the audit of other income of the company which consists of interest income on fixed deposits. As a Statutory Auditor how would CA X verify interest income on fixed deposits for the year 2019-20?

Ans. CA X, partner of XYZ & Company, would carry out the following audit procedure for verifying interest income on fixed deposits of ABC Limited:

1. Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
2. For deposits still outstanding as at the period- end, trace the same to the direct confirmations obtained from the respective bank/ financial institution.
3. Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
4. Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

Q-40 Discuss the audit procedures generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis.

Ans. The audit procedure generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis is as under:

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.

(ii) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.

Q-41 How will you vouch/verify the following?

(a) Trademarks and copyrights

(b) Investments income in the case of charitable institutions

(c) Contingent liabilities

(d) Leasehold rights

Ans. (a) Trademarks and Copyrights:

(i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.

(ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trademarks and copyrights have been duly registered.

(iii) Verify existence of copyright by reference to contract between the author & the entity and note down the terms of payment of royalty.

(iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalised.

(v) Ascertain that the legal life of the trademarks and copyrights has not expired.

(vi) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.

(b) Investment Income in the case of Charitable Institution:

(i) Vouching the amounts received with the dividend and interest counterfoils.

(ii) Checking the calculations of interest received on securities bearing fixed rates **of interest.**

(iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

(iv) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(c) Contingent liabilities:

(i) Inspect the minute books of the company to ascertain all contingent liabilitiesknown to the company.

(ii) Examine the contracts entered into by the company and the likelihood ofcontingent liabilities emanating therefrom.

(iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.

(iv) Examine bank letters in respect of bills discounted and not matured.

(v) Examine bank letters to ascertain guarantees on behalf of other companies orindividuals.

(vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.

(vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.

(viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

(d) **Leasehold Rights:**

(i) Inspect the lease or assignment thereof to ascertain the amount of premium, ifany, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument.

(ii) Ascertain that all the conditions, the failure to comply with which might result inthe forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.

(iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.

(v) Ensure that the outlay as well as any legal expenses incurred to acquire theleases which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

Q-42 A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context.

Ans. **Direct confirmation procedure**

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
  - — Agreeing the balance to bank statement received by the Company or internet/ onlinelogin to account in auditor's personal presence;
  - — Sending the audit team member to the bank branch along with the entity's personalto obtain balance confirmation from the bank directly.

Q-43 List out the steps to be taken by auditor while vouching/ verifying the 'Refund of General Insurance premium paid'.

Ans. **Refund of General Insurance Premium paid:** The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds:

(i) Ascertain the reasons for refund of insurance premium.

(ii) Examine insurance policy or cover note to find out the amount of premium.

(iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.

(iv) Scrutinise correspondence between the insurance company and the client.

(v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

Q-44 Newton Ltd. has made loans and advances on the basis of following securities to various borrowers. As an auditor what type of documents can be verified to ensure that the company holds a legally enforceable security?

(i) Shares and Debentures

(ii) Life Insurance Policy

(iii) Hypothecation of goods.

Ans. Documents to be seen in case of Securities:

Types of Security	Documents etc. to be seen
(i) Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(ii) Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(iii) Hypothecation of goods	Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

Q-45 Explain how you will verify the items given while conducting an audit of an entity:

(a) Recovery of Bad debts written off

(b) Receipt of Insurance claims

(c) Payment of Taxes

(d) Sale proceeds of scrap material

Ans. Recovery of Bad Debts written off: Recovery of bad debts written off is verified with reference to relevant correspondence and proper authorisation.

(i) Ascertain the total amount lying as bad debts and verify the relevant correspondence with the trade receivables whose accounts were written off as bad debt.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee. Letters from collecting agencies or from account receivables should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(v) Vouch acknowledgement receipts issued to account receivables or trustees.

(vi) Review the internal control system regarding writing off and recovery of bad debts

Receipt of Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims-

(i) The auditor should examine a copy of the insurance claim lodged with theinsurance company correspondence with the insurance company and with the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen.

(ii) The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy.

(iii) The copy of certificate/report containing full particulars of the amount of loss should also be verified.

(iv) The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the Statement of Profit and Loss is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.

Payment of Taxes:

(i) Obtain the computation of taxes prepared by the auditee and verify whether it is as per the Income Tax Act/GST Act/ Rules/ Notifications/ Circulars etc.

(ii) Examine relevant records and documents pertaining to payment of advance income tax and self assessment tax.

(iii) Payment on account of income-tax and other taxes like GST consequent upon a regular assessment should be verified by reference to the copy of the assessment order, notice of demand and the receipted challan acknowledging the amount paid.

(iv) The penal interest charged for non-payment should be debited to the interest account.

(v) Nowadays, electronic payment of taxes is also in trend. Such electronic payment of taxes by way of internet banking facility or credit or debit cards shall also be verified.

(vi) The assessee can make electronic payment of taxes also from the account of any other person. Therefore, it should be verified that the challan for making such payment is clearly indicating the PAN No./TAN No./TIN No./GSTIN etc. of the assessee on whose behalf the payment is made.\

Sale Proceeds of Scrap Material:

(i) Review the internal control on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.

(ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of scrap materials.

(iii) Review the production and cost records for determination of the extent of scrap materials that may arise in a given period.

(iv) Compare the income from the sale of scrap materials with the corresponding figures of the preceding three years.

(v) Check the rates at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.

(vi) See that scrap materials sold have been billed and check the calculations on the invoices.

(vii) Ensure that there exists a proper procedure to identify the scrap material and good quality material is not mixed up with it and sold as scrap

(viii) Make an overall assessment of the value of the realisation from the sale of scrap materials as to its reasonableness.

Q-46 While conducting audit of Air Space Ltd, the auditor observes that it has issued shares at discount to its creditors when its debt is converted into shares in pursuance of debt restructuring scheme in accordance with any guidelines specified by the Reserve Bank of India. Discuss explaining clearly the provisions relating to discount on issue of shares and its verification by the auditor.

Ans. Shares issued at a discountx

According to Section 53 of the Companies Act, 2013,

(1) a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.

(2) any share issued by a company at a discounted price shall be void. (2A) Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

(3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.

The auditor needs to check

(i) the movement in share capital during the year and wherever there is any issue,

(ii) he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

(iii) Further, auditor should also verify that in case a company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act,

In the given case of Air Space Ltd, it is clear that it can issue shares to its creditors when its debt is converted into shares in accordance with approved restructuring scheme.

Q-47 CA R is the statutory auditor of QRS Ltd. While performing testing of additions during the year, he wanted to verify that:

(i) All PPE (property, plant and equipment) are in the name of the entity he is auditing.

(ii) For all additions to land and building in particular, the auditor desires to have concrete about the ownership.

(iii) The auditor wants to know whether the entity has valid legal ownership rights over the PPE, where it is kept as security for any borrowings.

Advise the auditor on the audit procedure to be undertaken by him to establish the Rights and Obligations of the entity over the PPE.

Ans. Audit procedure to establish Rights and Obligations of the entity over PPE:

(i) In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, CA R, the statutory auditor of B Ltd, while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.

Verify whether the PPE additions have been approved by authorized personnel

(ii) For all additions to land, building in particular, CA R, the statutory auditor of B Ltd, should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

(iii) The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.

(iv) In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, CA R, the statutory auditor of B Ltd should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.

(v) In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

Q-48 Proft and Loss account of an organization shows various types of expenses like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations. What are the attributes that an auditor generally prefers for vouching these types of expenses?

Ans. **Attributes to be preferred for vouching other expenses:**

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 documents 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.

Q-49 How is "Cash and cash equivalents" disclosed in the Financial Statements as required under Schedule III (part I) to Companies Act, 2013?

Ans. Disclosure of Cash & Cash Equivalent in the Financial Statements:

Regarding Cash and cash equivalents- Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

(i) Cash and cash equivalents shall be classified as:

- (a) Balances with banks;
- (b) Cheques, drafts on hand;
- (c) Cash on hand;
- (c) Others (specify nature)

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

Q-50 While conducting audit of Air Space Ltd, the auditor observes that it has issued shares at discount to its creditors when its debt is converted into shares in pursuance of debt restructuring scheme in accordance with any guidelines specified by the Reserve Bank of India. Discuss explaining clearly the provisions relating to discount on issue of shares and its verification by the auditor.

Ans. Shares issued at a discount

According to Section 53 of the Companies Act, 2013,

(1) a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.

(2) any share issued by a company at a discounted price shall be void.

(2A) Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

(3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued. The auditor needs to check

(i) the movement in share capital during the year and wherever there is any issue,

(ii) he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

(iii) Further, auditor should also verify that in case a company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

In the given case of Air Space Ltd, it is clear that it can issue shares to its creditors when its debt is converted into shares in accordance with approved restructuring scheme.

Q-51 XYZ Ltd made huge additions to Intangible assets during the period 01-04-2021 to 31-03-2022 i.e period under audit. You have been appointed as an auditor and you want to verify the additions made to intangible assets during the period. Suggest the audit procedure to verify the additions to intangible assets.

Ans.1. Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account.

2. Check the arithmetical accuracy of the movement in intangible assets schedule.

For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures:

(i) For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.

(ii) Ensure that no cost related to research (or from the research phase of an internal project) gets recognized as intangible asset.

(iii) Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.

(iv) Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.

(v) Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.

(vi) In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

Q-52 Examine with reasons (in short) whether the following statements are correct or incorrect :

Electronic payment of Income Tax cannot be made by an assessee from the account of any other person.

Ans. **Incorrect:** Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards. The assessee can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. It is not necessary for the assessee to make payment of taxes from his own account in an authorized bank.

Q-53 While auditing the accounts of ABC Ltd, a member of audit team is not clear about :

(i) the criteria regarding classification of liability into current liability and non-current liability.

(ii) Classification of Reserves and Surplus

You being the senior member of audit team guide the member of the audit team about such criteria and classification as per general instructions for preparation of balance sheet as per Schedule III.

Ans.(i) A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

(ii) Reserves and Surplus shall be classified as:

(a) Capital Reserves;

(b) Capital Redemption Reserve;

(c) Securities Premium;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account;

(g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

Note: A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

Note: Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Q-54 Proceedings have been initiated against the company ABC Ltd for holding one of its property as benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder. State the disclosure requirements to be complied with by ABC Ltd as per Schedule III to the Companies Act, 2013.

Ans. **Details of Benami Property held**

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:-

(a) Details of such property, including year of acquisition,

(b) Amount thereof,

(c) Details of Beneficiaries,

(d) If property is in the books, then reference to the item in the Balance Sheet,

(e) If property is not in the books, then the fact shall be stated with reasons,

(f) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then the details shall be provided,

(g) Nature of proceedings, status of same and company's view on same.

MULTIPLE CHOICE QUESTIONS

1. While auditing the books of accounts of QHMP Ltd., CA. Ranker, the statutory auditor of the company, came to know that the management of the company has recognized internally generated goodwill as a fixed asset. CA. Ranker discussed with the management that according to accounting standards, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. However, the management is quite rigid to the accounting treatment followed for internally generated goodwill and not paying attention to the auditor. Thus, through an example, CA. Ranker explained which type of goodwill may be recognized as a fixed asset for which the management got justified. State which of the following examples the auditor must have given to the management?

(a) If an item meeting the definition of an intangible asset is acquired in a business combination, it forms part of the goodwill to be recognized at the date of the amalgamation.

(b) Only those goodwill needs to be recognized as a fixed asset which can be touched like physical assets, for example, land and buildings.

(c) Goodwill is recognised only when there is a contractual or other legal rights for a physical asset which shall not be amortized over the period.

(d) All of the above.

2. ………..is a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence/ non occurrence of one or more uncertain future events not wholly within the control of the entity:-

(a) Provisions (b) Reserves **(c) Contingent Liabilities** (d) Liability

3. While conducting the audit of Saraswati Ltd, a packaged water making company, it was found that a purchase of motor car was made in the name of the company. Your Article Assistant has performed the following audit procedures. Identify which of the following procedure is incorrect.

(a) Ascertain whether the purchase of car has been properly authenticated.

(b) Check invoice of the car dealer to confirm the purchase price

(c) Examine registration with Transport Authorities to verify the ownership

(d) Ensure that the motor car has been included in the Closing inventory of goods

Case Scenario-1

A partnership firm of Chartered Accountants, YZ and Associates were appointed as auditor of company UV Private Limited. The financial year for which YZ and Associates were to audit books of accounts of UV Private Limited began on 1 April, 2018 and ended on 31 March, 2019.

YZ and Associates consisted of four partners namely Mr. Y, Mr. Z, Mr. G and Mr. H. While auditing books of accounts of UV Private Limited for the period beginning on 1 April, 2018 and ending on 31 March, 2019, one of the partners of YZ and Associates namely Mr. H took up the expenses part for the purpose of audit.

The management of UV Private Limited had adopted various accounting policies and principles related to expenses which Mr. H as auditor of UV Private Limited was unable to understand.

Some of the issues which Mr. H was unable to understand are mentioned as follows:

(1) Power and Fuel expenses paid for the months of April, 2019 and May, 2019 have been included and shown as Power and Fuel expenses for the period beginning 1 April, 2018 and ending 31 March, 2019.

(2) Personal Rent Expenses of the son of one of the director, Mr. T of UV Private Limited have been shown as Rent Expenses of business of UV Private Limited.

(3) Repair and Maintenance Expenses for the months of February 2019 and March 2019 were still outstanding and were not shown in Balance Sheet of UV Private Limited.

(4) Repair and Maintenance Expenses for the financial year 1 April, 2018 to 31 March, 2019 were very high as compared to financial year 1 April, 2017 to 31 March, 2018. The auditor Mr. H asked the appropriate authority about the reasons for such huge differences in amounts of two financial years.

(5) While verifying the insurance expenses, the insurance policies were not shown to auditor Mr. H.

The above mentioned five points were some of the issues which Mr. H was unable to understand.

Answer the following questions:

1. As per the point number (1) mentioned in the above case, the Power and Fuel Expenses paid for the months of April 2019 and May 2019 must be shown under asset side of balance sheet of UV Private Limited as on 31 March, 2019 as:

(a) Outstanding Power and Fuel Expenses

(b) Prepaid Power and Fuel Expenses

(c) Power and Fuel Expenses

(d) Power and Fuel Expenses Payable

2. As per point number (2) mentioned above in the case, the Personal Rent Expenses of the son of one of the director Mr. T were added to Rent Expenses of business of UV Private Limited. The amount of personal rent expenses of the son of the director Mr. T must be:

(a) Subtracted from Rent Expenses of business of UV Private Limited

(b) Remain Added to Rent Expenses of business of UV Private Limited

(c) Again Added to Rent Expenses of business of UV Private Limited

(d) Subtracted twice from Rent Expenses of business of UV Private Limited

3. As per point number (3) mentioned above in the case, the Repair and Maintenance Expenses outstanding for the months of February 2019 and March 2019 must be shown under liability side of balance sheet of UV Private Limited as on 31 March, 2019 as:

(a) Prepaid Repair and Maintenance Expenses

(b) Repair and Maintenance Expenses

(c) Repair and Maintenance Expenses paid in advance

(d) Repair and Maintenance Expenses Payable

4. As per point number (4) mentioned in the case above, the auditor Mr. H asked the appropriate authority for reasons of huge differences in the amount of two financial years of repair and maintenance expenses. By appropriate authority Mr. H was referring to:

(a) All employees of UV Private Limited **(b) Management of UV Private Limited**

(c) Members of UV Private Limited (d) Any one director of UV Private Limited

5. As per point number (5) mentioned in the case above, in verifying insurance expenses the insurance policies would provide auditor Mr. H as:

(a) Invalid Supporting (b) No Supporting

(c) Lack of proper Supporting **(d) Valid Supporting**

CORRECT INCORRECT

1. **Statement I** : A capital reserve cannot be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realized.

Statement II : The amount of securities premium or capital redemption reserve account can be utilised only for the purposes specified in Sections 52 and 55 of the Companies Act, 2013, respectively.

(a) only Statement I is correct **(b) only Statement II is correct**

(c) both the statements are correct (d) both the statements are incorrect.

2. Sec. 52 of the Companies Act states that Security Premium Account can be applied by the Company for one of the purpose mentioned below. Which of the following is a CORRECT option?

(a) To adjust loss on revaluation of Assets

(b) To pay dividend to equity shareholders

(c) Providing for the premium payable on redemption of Preference shares

(d) To use it as working capital for its business.

❑

NOTES

CHAPTER-10

THE COMPANY AUDIT

Q-1 Discuss which class of companies are specifically exempt from the applicability of CARO 2016.

Ans. **CARO 2016 specifically exempts the following class of companies:**

(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 under clause (62) of section 2 of the Companies Act;

(v) A small company as defined under clause (85) of section 2 of the Companies Act; and

(vi) 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 rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore 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, 2013 (including revenue from discontinuing operations) exceeding rupees ten crores during the financial year asper the financial statements.

Q-2 CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of Rs. 30,000. However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?

Ans. **Provisions and Explanation:** For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than Rs. 30,000 but which may extend to Rs. 5,00,000.

Q-3 "The remuneration of the auditor of a company shall be fixed in its general meeting or in suchmanner as may be determined therein." Explain with reference to provisions of the Companies Act,2013.

Ans. As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein. However, board may fix remuneration of the first auditor appointed by it.

Further, the remuneration, in addition to the fee payable to an auditor, includes the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company. Therefore, it has been clarified that the remuneration to Auditor shall also include any facility provided to him.

Q-4 State the matters to be included in the auditor's report as per CARO, 2016 regarding-

(i) Default in repayment of loans or borrowing to a financial institution, bank etc.

(ii) Fraud by the company or on the Company by its officers or employees.

Ans. of a company to which CARO applies shall include a statement on the following matters, namely-

(i) whether the company has defaulted in repayment of loans or borrowing to a financialinstitution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

(ii) whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

Q-5 Where a company is required to constitute an Audit Committee, all appointments of an auditor under this section shall be made after taking into account the recommendations of such committee. Explain stating also the class of companies required to constitute Audit Committee.

Ans. **Applicability of section 177 i.e. Constitution of Audit Committee:** Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

It is important to know that in addition to ***listed public companies***, following classes of companies shall constitute an Audit Committee -

(i) all public companies with a paid up capital of ten crore rupees or more;

(ii) all public companies having turnover of one hundred crore rupees or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Q-6 The first auditors of Bhartiya Petrol Ltd., a Government company, were appointed by the Board of Directors. Analyse.

Ans. A "Government company" is a company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Section 139(7) provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditor made by the Board of Directors of Bhartiya Petrol Ltd., is null and void.

Q-7 State the matters to be included in the auditor's report as per CARO, 2016, regarding:

(i) Private Placement of Preferential Issues.

(ii) Utilisation of IPO and further public offer.

Ans.(i) **The auditor is required to report as per clause xiv of paragraph 3 of CARO 2016,** whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

(ii) **It is duty of the auditor to report as per clause ix of paragraph 3 of CARO 2016,** whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

Q-8 What are the provisions prescribed under Companies Act, 2013 in respect of ceiling on number of audits in a company to be accepted by an auditor?

Ans **Ceiling on number of Audits:**

1. Section 141(3)(g) of the Companies Act, 2013 prescribes that a person shall not be eligible for appointment as an auditor of a company namely – a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 crore.
2. In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits.
3. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

Q-9 M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of Rs. 10 each) in Enn Ltd. having market value of ₹ 1,50,000. One of the shareholders, complains that the appointment of RM & Co. as an auditor is invalid because it incurred disqualification u/s 141 of the Companies Act, 2013. Analyse and advise.

Ans. As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000. In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA. M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹ 50,000 only (5,000 shares x ₹ 10 per share). Therefore, M/s RM & Co. is not disqualified for appointment as an auditors of Enn Ltd. as the relative of CA. R (i.e. partner of M/s RM & Co.) is holding the securities in Enn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

Q-10 The auditor is not required to report on the matters specified in sub-section (1) of Section 143 unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. Explain clearly stating the matters for which the auditor has to perform his duty of inquiry under this section.

Ans. Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

Section 143(1) - Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)."

Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

Q-11 The auditor CA Z appointed under section 139 was removed from his office before the expiry of his term by an ordinary resolution of the company. Comment explaining clearly the procedure of removal of auditor before expiry of term.

Ans. **Removal of Auditor before Expiry of Term:** According to Section 140 (1) the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government .

(1) The application to the Central Government for removal of auditor shall be made in Form ADT- 2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

(2) The application shall be made to the Central Government within thirty days of the resolution passed by the Board.

(3) The company shall hold the general meeting within sixty days of receipt of approval of the Central Government for passing the special resolution.

It may be noted that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

By applying the above provisions, it may be concluded that the action of the company for removal of the auditor CA Z before expiry of term is not justified and auditor may be removed from his office only by following the above mentioned procedure.

Q-12 The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.

Ans. **Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

(i) Sharing of expertise.

(ii) Advantage of mutual consultation.

(iii) Lower workload.

(iv) Better quality of performance.

(v) Improved service to the client.

(vi) Displacement of the auditor of the company taken over in a takeover often obviated.

(vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance

Q-13 According to Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report in accordance with the relevant provisions of the Act. Explain clearly the relevant provisions relating to signing of report.

Ans. **Duty to Sign the Audit Report:** As per **section 145** of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company, in accordance with the provisions of **section 141(2)**.

Section 141(2) of the Companies Act, 2013 states that where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor's report shall be read before the company in general meeting.

Q-14 The auditor shall make a report to the members of the company on the accounts examined by him. Explain with reference to relevant provisions of the Companies Act, 2013.

Ans. **Right to report to the members of the company on the accounts examined by him –** The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company' s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Q-15 Under sub-section (3) of section 141 of the Companies Act, 2013 along with Rule 10 of the Companies (Audit and Auditors) Rules, 2014, state the persons who shall not be eligible for appointment as an auditor of a company

Ans. Under **sub-section (3) of section 141** along with **Rule 10** of the Companies (Audit and Auditors) Rules, 2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as an auditor of a company, namely-

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner -

(i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company;

It may be noted that the relative may hold security or interest in the company of face value not exceeding ₹ 1,00,000.

It may also be noted that the condition of ₹ 1,00,000 shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

It may also be noted that in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor **within 60** days of such acquisition or interest.

(ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of ₹ 5,00,000; or

(iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the Company or its Subsidiary, or its Holding or Associate Company or a Subsidiary of such Holding Company, in excess of ₹ 1,00,000.

(e) a person or a firm who, whether directly or indirectly has business relationship with the Company, or its Subsidiary, or its Holding or Associate Company or Subsidiary of such holding company or associate company, of such nature as may be prescribed;

(f) a person whose relative is a Director or is in the employment of the Company as a director or key Managerial Personnel.

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ` 100 crore.

(h) a person who has been convicted by a Court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction.

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in **section 144**.

Q-16 Mr. A, a chartered accountant, has been appointed as an auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2016, which assignment he accepted. Subsequently in January, 2017 he joined Mr. B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner. Analyse and explain.

Ans. **Provisions and Explanation:** Section 141(3)(c) of the Companies Act, 2013 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (4) of Section 141 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) of Section 141, he shall be deemed to have vacated his office as an auditor.

Conclusion: In the present case, Mr. A, an auditor of Laxman Ltd., joined as partner with Mr. B, who is Manager Finance of Laxman Limited. The given situation has attracted sub-section (3)(c) of Section 141 and, therefore, he shall be deemed to have vacated office of the auditor of Laxman Limited in accordance with sub-section (4) of section 141.

Q-17 The first auditor of Bhartiya Petrol Ltd., a Government company, was appointed by the Board of Directors. Analyse and Explain

Ans. **Provisions and Explanation:** In the case of a Government Company, the appointment of first auditor is governed by the provisions of Section 139(7) of the Companies Act, 2013 which states that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company. Hence, in the case of Bhartiya Petrol Ltd., being a government company, the first auditor shall be appointed by the Comptroller and Auditor General of India.

Conclusion: Thus, the appointment of first auditor made by the Board of Directors of Bhartiya Petrol Ltd., is null and void.

Q-18 Explain the manner and procedure of selection and appointment of auditors as per Rule 3 of Companies (Audit and Auditors) Rules, 2014

Ans. **Manner and procedure of selection and appointment of auditors-** Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

(1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

(2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.

(3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

(4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

(5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

(6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

(7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

Q-19 When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole. Explain

Ans. **Using the Work of another Auditor*:*** When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor**". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(i) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and

(ii) advise the other auditor of the significant accounting, auditing and reportingrequirements and obtain representation as to compliance with them. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor' s procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other audit or.

Q-20 Why Central Government permission is required, when the auditors are to be removed before expiry of their term, but the same is not needed when the auditors are changed after expiry of their term?

Ans. **Permission of Central Government for Removal of Auditor Under Section 140(1) of the Companies Act, 2013:** Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence.

Further, in case of conflict of interest the shareholders may remove the auditors in their own interest. Therefore, law has provided this safeguard so that central government may know the reasons for such an action and if not satisfied, may not accord approval. On the other hand if auditor has completed his term i.e. has submitted his report and thereafter he is not re-appointed then the matter is not serious enough for central government to call for its intervention.

In view of the above, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

Q-21 **Examine** "**Section 139(1)** of the Companies Act, 2013 provides that every company shall, atthe first annual general meeting appoint an auditor who shall hold office till theconclusion of its sixth annual general meeting".

Ans. Appointment of Subsequent Auditors in case of Non Government Companies: **Section 139(1)** of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

(i) The company shall place the matter relating to such appointment of ratificationby member at every Annual General Meeting.

(ii) Before such appointment is made, the written consent of the auditor to suchappointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

(iii) The certificate shall also indicate whether the auditor satisfies the criteria provided in **section 141**.

(iv) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

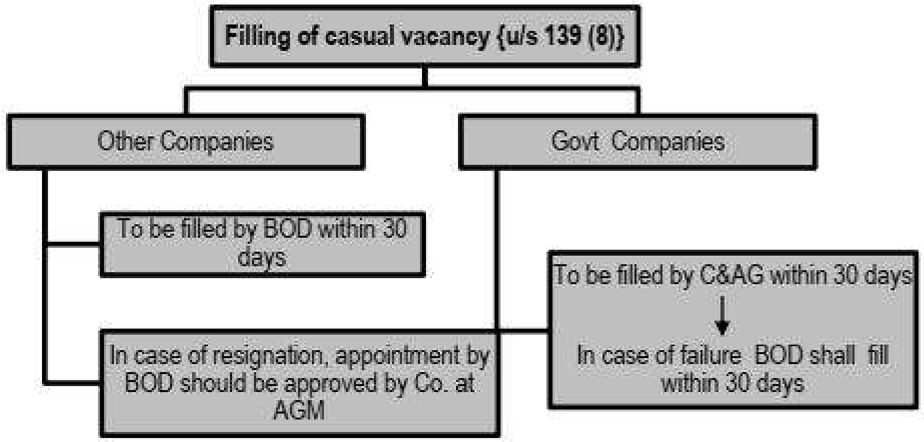
Q-22 **Examine** Filling of a casual vacancy of auditor in respect of a company audit.

Ans.(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

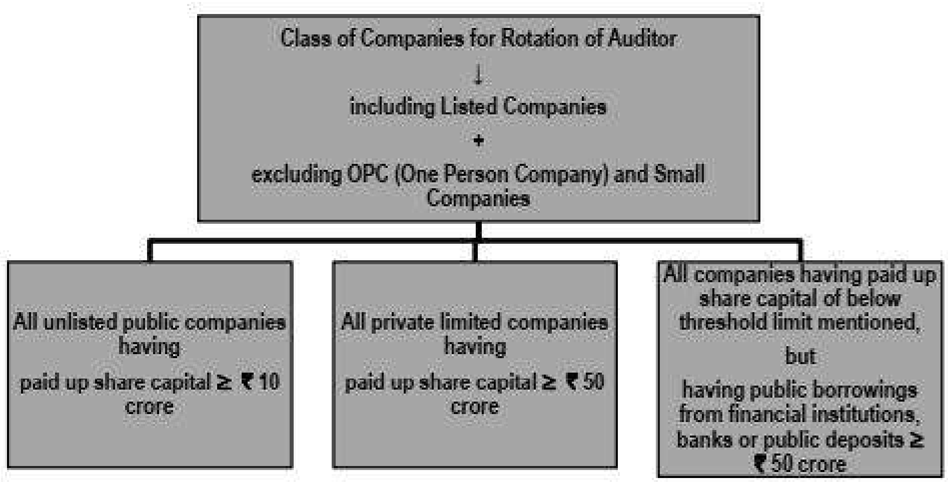
It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



Casual Vacancy by Resignation: As per **section 140(2)** the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form ADT–3** (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140(3).

Q-23 Rano Pvt. Ltd. is a private limited Company, having paid up share capital of ₹ 45 crore but having public borrowing from nationalized banks and financial institutions of ₹ 40 crore. Advise the company on the applicability of rotation of auditors.

Ans. **Applicability of Section 139(2) Rotation of Auditor**: As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-



(I) all unlisted public companies having paid up share capital of rupees ten crore ormore;

(II) all private limited companies having paid up share capital of rupees fifty crore or more;

(III) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

From the above, it can be concluded that rotational provisions would not be applicable.

Q-24 Board of Directors of "XYZ Ltd." found the auditors of the Company acted in a fraudulent manner, and decided to remove the auditors in board's meeting. Comment on the action of Board of Directors and describe correct procedure to be followed for removal of auditors before expiry of their term.

Ans. Board of Directors of "XYZ Ltd" cannot remove the auditors in Board meeting. According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014-

i. The application to the Central Government for removal of auditor shall be made in Form ADT-2and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

ii. The application shall be made to the Central Government within 30 days of the resolution passed by the Board.

iii. The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

iv. It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

Q-25 Auditors have right to attend only those general meetings at which the accounts audited by them are to be discussed. Comment.

Ans. The auditors of a company are entitled to attend any general meeting of the company and the right is not only restricted to those at which the accounts audited by them are to be discussed, he is also entitled to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

According to the section 146 of the Companies Act 2013,"all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor."

Thus, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

Q-26 "MMJ Ltd., an unlisted public company, did not appoint any internal auditor for the financial year ending on 31st March, 2019. The company had paid up capital of ₹ 20 crores and reserves of ₹ 25 crores. Its turnover for the preceeding 3 years were ₹ 75 crores for the year ended 31st March, 2018, ₹ 150 crores for March, 2017 and ₹ 190 crores for March, 2016. The company had availed term loan from the bank of ₹ 130 crores. The outstanding balance of the term loan as on 31st March, 2018 is ₹ 90 crores." As an auditor of the company, how would you deal with the above?

Ans. **Every unlisted public company having-**

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year;

In view of above provisions, MMJ Ltd would have to appoint internal auditor for the financial year 31-03-2019 because it had availed a term loan from the bank of ₹ 130 Crores. The outstanding balance of term loan as on 31-03-2018 ₹ 90 crores would not make any difference because section is contemplating outstanding at any point of time during the preceding financial year.

Q-27 "Mr. A is offered by ABC Ltd. for appointment as cost auditor and asked to certify certain requirements before such appointment." Discuss those requirements with reference to the provisions of the Companies Act, 2013.

Ans. **Cost Auditor:** Rule 6 of the Companies (Cost Records and audit) rules, 2014 required the companies prescribed under the said rules to appoint an auditor within 180days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

(1) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;

(2) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;

(3) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and

(4) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

Q-28 ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.

Ans. Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Q-29 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.

Ans. **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:

(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

(d) in directing the engagement team's efforts;

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

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

Q-30 The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. How will you deal as an auditor ?

Ans. Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report. It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹ 1 crore, however, reporting under CARO, 2016 is required.

Q-31 M Ltd. has given certain loans to related parties and also has accepted certain deposits. As an auditor, how will you include the above items in paragraph 3 of CARO, 2016?

Ans.

1. Clause (iii) of paragraph 3 of CARO, 2016 states

Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,

(i) Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;

(ii) Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(iii) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

2. Further, Clause (v) of paragraph 3 of CARO, 2016 states in case the company has accepted deposits,

(i) whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any: ether relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated;

(ii) If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

In the given situation, M Ltd. has given certain loans to related parties and also has accepted certain deposits. Thus, the auditor is required to report the same as per clause (iii) and (v) of Paragraph 3 of CARO, 2016.

Q-32 The auditor has to make inquires on certain matters under section 143(1) of Companies Act, 2013. Discuss those matters.

Ans. The auditor has to make inquires on following matters under section 143(1) of Companies Act, 2013:-

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Q-33 "ABC & Co." is an Audit Firm having partners "Mr. A", "Mr. B" and "Mr. C", Chartered Accountants. "Mr. A", "Mr. B" and "Mr. C" are holding appointment as an Auditor in 4, 6 and 10 Comp anies respectively.

(i) Provide the maximum number of Audits remaining in the name of "ABC & Co."

(ii) Provide the maximum number of Audits remaining in the name of individual partner i.e. Mr. A, Mr. B and Mr. C.

(iii) Can ABC & Co. accept the appointment as an auditor in 60 private companies having paidup share capital less than ₹ 100 crore, 2 small companies and 1 dormant company?

(iv) Would your answer be different, if out of those 60 private companies, 45 companies are having paid-up share capital of ₹ 110 crore each?

Ans. **Fact of the Case:** In the instant case, Mr. A is holding appointment in 4 companies, whereas Mr. B is having appointment in 6 Companies and Mr. C is having appointment in 10 Companies. In aggregate all three partners are having 20 audits.

Provisions and Explanations: Section 141(3)(g) of the Companies Act, 2013 states that the following persons shall not be eligible for appointment as an auditor of a company i.e. a person who is in full time employment elsewhere; or a person, or a partner of a firm holding appointment as its auditor, if such person, or partner is at the date of such appointment, or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ₹100 crore.

As per section 141(3)(g), this limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account.

Conclusion:

(i) Therefore, ABC & Co. can hold appointment as an auditor of 40 more companies:

Total Number of Audits available to the Firm Number = 20*3	= 60
of Audits already taken by all the partners	
In their individual capacity = 4+6+10	= 20
Remaining number of Audits available to the Firm	= 40

(ii) With reference to above provisions an auditor can hold more appointment as auditor = ceiling limit as per section 141(3)(g)- already holding appointments as an auditor. Hence (1) Mr. A can hold: 20 - 4 = 16 more audits. (2) Mr. B can hold 20-6 = 14 more audits and (3) Mr. C can hold 20-10 = 10 more audits.

(iii) In view of above discussed provisions, ABC & Co. can hold appointment as an auditor in all the 60 private companies having paid-up share capital less than ₹ 100 crore, 2 small companies and 1 dormant company as these are excluded from the ceiling limit of company audits given under section 141(3)(g) of the Companies Act, 2013.

(iv) As per fact of the case, ABC & Co. is already having 20 company audits and they can also accept 40 more company audits. In addition they can also conduct the audit of one person companies, small companies, dormant companies and private companies having paid up share capital less than ‘ 100 crores. In the given case, out of the 60 private companies, ABC & Co. is offered 45 companies having paid-up share capital of ₹110 crore each.

Therefore, ABC & Co. can also accept the appointment as an auditor for 2 small companies, 1 dormant company, 15 private companies having paid-up share capital less than ₹ 100 crore and 40 private companies having paid-up share capital of ₹110 crore each in addition to above 20 company audits already holding.

Q-34 When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole. Explain.

Ans. **Using the Work of another Auditor***:* When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor**". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and

(b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

Q-35 Audit committee is to be constituted by every public company to ensure better standards of corporate governance.

Ans. **Incorrect***:* Under Section 177 of Companies Act, 2013 read together with Rule 4 of Companies (Appointment and qualification of Directors) Rules, 2014 prescribe that audit committee is to be constituted by every listed public company and following classes of public companies only: -

(i) the Public Companies having paid up share capital of ten crore rupees or more; or

(ii) the Public Companies having turnover of one hundred crore rupees or more; or

(iii) the Public Companies which have, in aggregate, outstanding loans, debentures and deposits, exceeding fifty crore rupees:

Hence, the statement that all public companies are required to constitute audit committee is incorrect.

Q-36 The auditor has to report under section 143 of companies act, 2013 whether company has adequate internal controls in place and overall effectiveness of such internal controls.

Ans. **Incorrect:** Under provisions of Section 143 of the companies Act, 2013, auditor has to report whether the company has adequate *internal financial controls with reference to financial* statements in place and operating effectiveness of such controls. The auditor has to report on adequacy and effectiveness of internal financial controls only and not internal controls.

Q-37 Rule 3 of CAAR, 2014 prescribes the manner and procedure of selection and appointment of auditors. Explain that procedure in detail.

Ans. Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

(1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Commi ttee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

(2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.

(3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

(4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

(5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

(6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

(7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

Q-38 At the AGM of HDB Pvt. Ltd., Mr. R was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to pursue his career in banking sector. The Board of Director has appointed Mr. L as the statutory auditor in board meeting within 30 days.

Comment on the matter with reference to the provisions of Companies Act, 2013.

Ans. As per Section 139(8), any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

Further, as per section 140(2) the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar. In the instant case, R resigned after three mon ths of his appointment as statutory auditor as he wanted to pursue his career in banking sector.

Therefore, the board of director has appointed Mr. L as the statutory auditor with in 30 days is in order subject to such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board. Further, it is also the duty of the auditor to file, within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar in compliance with section 140(2) of the Companies Act, 2013.

Q-39 M/s. ABC & Co. is an Audit firm, having partners CA. A, CA. B and CA. C. The firm has been offered the appointment as an Auditor of XYZ Ltd. for the Financial Year 2019-20.

Mr. D, the relative of CA. A, is holding 25,000 shares (face value of ₹ 10 each) in XYZ Ltd. having market value of ₹ 90,000. Are M/s. ABC & Co. qualified to be appointed as Auditors of XYZ Ltd.?

Ans. As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s ABC & Co. is an audit firm having partners CA. A, CA. B and CA. C. Mr. D is a relative of CA. A and he is holding shares in XYZ Ltd. of face value of ₹ 2,50,000 (25,000 shares x rupees 10 per share) . Market value of ₹ 90,000 would not be relevant.

Therefore, M/s ABC & Co. is disqualified for appointment as an auditors of XYZ Ltd. as the relative of CA. A (i.e. partner of M/s ABC & Co.) is holding the securities in XYZ Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

Q-40 The term "relative", as defined under the Companies Act, 2013, means anyone who is closely related to another.

Ans. **Incorrect:** The term "relative", as defined under the Companies Act, 2013, mean s anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son's wife, Daughter, Daughter's husband, Brother (including step- brother), Sister (including step-sister).

Q-41 According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by passing a Board resolution.

Ans. **Incorrect**: According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014.

Q-42 "CA. NM who is rendering management consultancy service to LA Ltd. wants to accept offer letter for appointment as an auditor of the LA Ltd. for the next financial year." Discuss with reference to the provision of the Companies Act, 2013.

Ans. **Section 141(3)(i) of the Companies Act, 2013** disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in management consultancy service as provided in section 144. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which are as under:

(i) Accounting and book keeping services
(ii) Internal audit.
(iii) Design and implementation of any financially information system.
(iv) Actuarial services
(v) Investment advisory services.
(vi) Investment banking services.
(vii) Rendering of outsourced financial services
(viii) Management services and
(ix) Any other kind of services as may be prescribed

Therefore, CA. NM is advised not to accept the assignment of auditing as the management consultancy service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

Q-43 Enumerate the circumstances under which the retiring auditor can be re-appointed.

Ans. **Re-appointment of auditor:** A retiring auditor may be re-appointed at an annual general meeting, if-

(i) he is not disqualified for re-appointment.

(ii) he has not given the company a notice in writing of his unwillingness to be re-appointed; and

(iii) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

(iv) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

Q-44 State the matters to be included in auditor's report as per CARO, 2016 regarding:

(i) Default in repayment of loan or borrowing to a financial institution, bank etc.

(ii) Fraud by the company or on the company by its officers or employees.

Ans. **Matters to be included in Auditor's report as per CARO 2016:**

(i) Clause (viii) of Para 3 of CARO, 2016, requires the auditor to report whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

(ii) Clause (x) of Para 3 of CARO, 2016, requires the auditor to report whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

Q-45 Provisions regarding appointment of Auditors -

(i) First auditor of a Government company and a Non-Government company.

(ii) Subsequent auditor of a Government company and a Non- Government company.

Ans. (i) **Appointment of First Auditor of a Government Company:** Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Appointment of First Auditor of a Non-Government Company: As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

(ii) **Appointment of Subsequent Auditor of a Government Company:** As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Appointment of Subsequent Auditor of a Non-Government Company: As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

Q-46 "The company has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilized these funds for repayment of long term loans and advances." Advise the auditor regarding reporting requirements under CARO, 2016.

Ans. **The auditor is required to report as per clause xiv of paragraph 3 of CARO 2016,** whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

In view of the above clause, the auditor would report that funds raised by the company for expansion and diversification of business have not been used for the said purpose rather the company has utilised these funds for repayment of long term loans and advance.

Q-47 Shine Industries is an electricity generating company engaged in generation of electricity for captive consumption. Its gross turnover was INR 68 crores during the immediately preceding financial year.

Management of shine industries has not maintained any cost records as they felt that there is no requirement for them· to maintain any cost records or conduct any cost audit. Comment.

Ans. **Applicability for Maintenance of Cost Records:** Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ' 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account. These companies include Foreign Companies defined in sub-section (42) of section 2 of the Act, but exclude a company classified as a Micro enterprise or a Small enterprise including as per the turnover criteria provided under Micro, Small and Medium Enterprises Development Act, 2006. The said rule has divided the list of companies into (A) Regulated sectors and (B) Non-regulated sectors.

Cost Audit Rules Not to Apply in Certain Cases: The requirement for cost audit under these rules shall not be applicable to a company which is covered under Rule 3, and,

(i) whose revenue from exports, in foreign exchange, exceeds 75% of its total revenue; or

(ii) which is operating from a special economic zone.

(ii) which is engaged in generation of electricity for captive consumption through Captive Generating Plant.

Conclusion: Since Shine Industries is having an overall turnover of ‘ exceeding 35 crore during the immediately preceding financial year, therefore, it is required to include cost records in its books of account but is not required to get its accounts audited because Cost Audit Rules are not applicable on Companies engaged in generation of electricity for captive consumption.

Audit Rules are not applicable on Companies engaged in generation of electricity for captive consumption.

Q-48 The recommendation for appointment of auditors is only one of the several functions performed by audit committee. Discuss atleast four other key responsibilities of Audit Committee in accordance with Section 177 of the Companies Act, 2013.

Ans. Audit committee performs wide functions. The recommendation for appointment of auditors is only one of the several functions performed by audit committee. Under section 177 of Companies Act, 2013, audit committee is responsible for following actions :-

(i) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;

(ii) review and monitor the auditor’s independence and performance, and effectiveness of audit process;

(iii) examination of the financial statement and the auditors’ report thereon;

(iv) approval or any subsequent modification of transactions of the company with related parties;

(v) scrutiny of inter-corporate loans and investments;

(vi) valuation of undertakings or assets of the company, wherever it is necessary;

(vii) evaluation of internal financial controls and risk management systems;

(viii) monitoring the end use of funds raised through public offers and related matters.

Hence, audit committee oversees range of matters including those related to making recommendation for appointment of auditors.

Q-49 CA Raj, an auditor was removed by PQR Ltd. before the expiry of his term. Discuss the procedure to be taken by PQR Ltd to appoint an auditor other than retiring auditor under Sec. 140(4) of the Companies Act, 2013.

Ans. In the given question, CA Raj was removed by PQR Ltd. before the expiry of his term and PQR Ltd wants to appoint an auditor other than retiring auditor i.e CA Raj who was removed.

Section 140(4) lays down procedure to appoint an auditor other than retiring auditor who was removed-

(1) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or as the case may be, ten years, as provided under **sub-section (2) of section 139**.

(2) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

(3) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so, -

(a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and

(b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

Q-50 What are the prohibited services for auditor as per Companies Act, 2013 ?

Ans. **Prohibited services for an auditor as per Companies Act, 2013 are stated in Section 144. Section 144 of the Companies Act, 2013** prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely :

(i) accounting and book keeping services;

(ii) internal audit;

(iii) design and implementation of any financial information system;

(iv) actuarial services;

(v) investment advisory services;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(ix) any other kind of services as may be prescribed.

Q-51 The auditor's requirement to report under clause (X) of paragraph 3 of the Companies (Auditor's Report) Order, 2016 is restricted to frauds noticed or reported during the year.

Explain what auditors may consider for reporting under this clause?

Ans. The auditor is required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order,2016,

Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

(i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified, the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

   (i) While reporting under this clause with regard to the nature and the amount involved of the frauds notice do reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

Q-52 Clue Ltd. is a Public unlisted company having paid-up share capital of ‘ 9 crores and public borrowings from the financial institutions of ‘ 51 crores. They appointed M/s Pray and Co., A Chartered Accountant firm as the statutory auditor in its annual general meeting for 11 years.

(i) Is the manner of rotation of auditor applicable in case of Clue Ltd.?

(ii) Whether the appointment of M/s Pray and Co. is valid?

Ans.(i) As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

(i) all unlisted public companies having paid up share capital of rupees ten crore or more;

(ii) all private limited companies having paid up share capital of rupees fifty crore or more;

(iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

In the given case, Clue Ltd is an Unlisted Public company, any having paid up share capital of ‘ 9 crores and public borrowings from financial institutions of ‘ 51 crores. So, applying the above provisions to the given problem, although paid up share capital of Clue Ltd is below threshold limit of ‘ 10 crores yet the Company is having public borrowings from financial institutions worth ‘ 51 crores i.e above ‘ 50 crores.

Therefore, manner of rotation of auditors is applicable in case of Clue Ltd.

(ii) Clue Ltd., an unlisted public company is covered by the rotational provisions, appointed M/s Pray and Co., a Chartered Accountant firm, as the statutory auditor in its AGM for 11 years. Here, the appointment of M/s Pray & Co. is not valid as the appointment can be made only for one term of five consecutive years and then another one more term of five consecutive years. It can’t be appointed for two terms in one AGM only. Further, a cooling period of five years from the completion of term is required i.e. the firm can’t be re-appointed for further 5 years after completion of two terms of five consecutive years.

Keeping in view above, the appointment of M/s Pray and Co. is not valid.

Q-53 RJ Limited is in the business of trading of cycles having Head Office at Delhi and branch at Mumbai. Statutory audit of Head Office was to be done by CA D and statutory audit of branch at Mumbai was to be done by CA M. During the course of audit by CA D at head office, CA D Wanted to visit branch at Mumbai and verify the inventory records at Mumbai.

The management of RJ Limited did not allow CA D to visit Mumbai office and verify the inventory records as the branch audit of Mumbai was already being undertaken by another CA M.

In the above situation, discuss the rights available with CA D in terms of the Companies Act, 2013.

Ans. Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per Section143(8).

In the given case where CA D was appointed as Statutory Auditor of Head office of RJ Ltd and CA M was appointed to conduct Statutory Audit of Branch office of RJ Ltd., CA D wanted to visit Mumbai Branch to verify the inventory records at Mumbai but management of RJ Ltd did not allow CA D to verify the inventory records at its Mumbai Branch on the ground that branch audit was already being undertaken by another CA M.

Keeping in view the above provisions of the Companies Act and facts of the case, it can be concluded that CA D has a right to visit the branch for verifying inventory records at Mumbai even if the branch accounts are audited by another auditor CA M, if he considers it necessary to do so for the performance of his duties as an auditor.

Q-54 Rule 3 of CAAR, 2014 prescribes the manner and procedure of selection and appointment of auditors. Explain that procedure in detail.

Ans. Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

(1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

(2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.

(3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

(4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

(5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

(6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

(7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

Q-55 At the AGM of HDB Pvt. Ltd., Mr. R was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to pursue his career in banking sector. The Board of Director has appointed Mr. L as the statutory auditor in board meeting within 30 days. Comment on the matter with reference to the provisions of Companies Act, 2013.

Ans. As per Section 139(8), any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

Further, as per section 140(2) the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar. In the instant case, R resigned after three months of his appointment as statutory auditor as he wanted to pursue his career in banking sector.

Therefore, the board of director has appointed Mr. L as the statutory auditor with in 30 days is in order subject to such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board. Further, it is also the duty of the auditor to file, within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar in compliance with section 140(2) of the Companies Act, 2013.

Q-56 M/s. ABC & Co. is an Audit firm, having partners CA. A, CA. B and CA. C. The firm has been offered the appointment as an Auditor of XYZ Ltd. for the Financial Year 2019-20. Mr. D, the relative of CA. A, is holding 25,000 shares (face value of ‘ 10 each) in XYZ Ltd. having market value of ‘ 90,000. Are M/s. ABC & Co. qualified to be appointed as Auditors of XYZ Ltd.?

Ans. As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ‘ 1,00,000.

In the instant case, M/s ABC & Co. is an audit firm having partners CA. A, CA. B and CA. C. Mr. D is a relative of CA. A and he is holding shares in XYZ Ltd. of face value of ‘ 2,50,000 (25,000 shares x rupees 10 per share). Market value of ‘ 90,000 would not be relevant.

Therefore, M/s ABC & Co. is disqualified for appointment as an auditors of XYZ Ltd. as the relative of CA. A (i.e. partner of M/s ABC & Co.) is holding the securities in XYZ Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

Q-57 During the audit of PQR Ltd. you as an auditor requested officers of the company to have access to secretarial records and correspondence which they refused to provide. Comment.

Ans. Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.
2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the secretarial records and correspondence.

3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.

4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.

5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Q-58 In exercise of the powers conferred by the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 141(3)(g) of the Companies Act, 2013).

Explain the provisions prescribed under Companies Act, 2013 in respect of ceiling on number of audits in a company to be accepted by an auditor.

Ans. Ceiling on number of Audits:

1. Before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 141(3)(g) of the Companies Act, 2013 which prescribes that a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such person or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than ` 100 crore, shall not be eligible for appointment as an Auditor of a Company.

2. In the case of a firm of auditors, it has been further provided that 'specified number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere. This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits.

3. **Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.**

Q-59 Discuss the Provisions regarding appointment of Auditors -

(i) First auditor of a Government company and a Non-Government company.

(ii) Subsequent auditor of a Government company and a Non- Government company.

Ans. (i) Appointment of First Auditor of a Government Company: Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Appointment of First Auditor of a Non-Government Company: As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

(ii) **Appointment of Subsequent Auditor of a Government Company:** As per Section 139(5) of the Companies Act, 2013, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

Appointment of Subsequent Auditor of a Non-Government Company: As per section 139(1) of the Companies Act, 2013, every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

Q-60 Before appointment is made under **Section 139(1)** of the Companies Act, 2013, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor. Explain stating clearly provisions of Section 139(1) along with **Rule** 4 of The Companies (Audit and Auditors) Rules, 2014.

Ans. **Section 139(1)** of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

(i) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

(ii) **Under Rule 4** of The Companies (Audit and Auditors) Rules, 2014, the said certificate shall state the following:-

(a) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Act, the Chartered Accountants Act, 1949 and the rules or regulations made thereunder;

(b) the proposed appointment is as per the term provided under the Act;

(c) the proposed appointment is within the limits laid down by or under the authority of the Act;

(d) the list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

(iii) The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

Q-61 Harry Limited appointed CA Lakshman as an auditor of the company for a term of 5 years. Further, the company offered him the services of actuarial which were also approved by the board of directors. As an auditor, how would you deal with such situation?

Ans. Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

(i) accounting and book keeping services;

(ii) internal audit;

(iii) design and implementation of any financial information system;

(iv) actuarial services*;

(v) investment advisory services;

(vi) investment banking services;

(vii) rendering of outsourced financial services;

(viii) management services; and

(ix) any other kind of services as may be prescribed.

*Actuarial services broadly pertain to services relating to evaluation of financial impact of risks using range of mathematical and statistical methods In the given situation, CA. Lakshman was appointed as an auditor of Harry Ltd for a term of 5 years. He was offered additional services of actuarial which was also approved by the Board of Directors. CA. Lakshman is advised not to accept the services as these services are specifically notified in the services not to be rendered by him as an auditor as per section 144 of the Act.

Q-62 Explain the Reporting requirements the auditor should ensure under CARO 2020 related to PPE and Intangible assets.

Ans. Reporting for PPE and Intangible assets - Clause (i) of Para 3 of CARO ,2020, requires the auditor to include a statement in the auditor's report on the following matters, namely -

(i) (a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;

(B) whether the company is maintaining proper records showing full particulars of intangible assets;

(b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:-

Description of property	Gross carrying value	Held in name of	Whether promoter, promoter, director or their relative or employee	Period held –indicate range, where appropriate	Reason for not being held in name of company*
					*also indicate if in dispute

(d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

(e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements.

Q-63 State with reasons whether the following statements are correct or incorrect.

1. As per section 139(5) of the Companies Act, 2013, in the case of a government company, board of directors shall appoint the subsequent auditor within a period of 60 days from the commencement of the financial year.
2. Auditor has to disclose the impact, if any, of the pending litigations on the financial position of the auditee in his audit report.

Ans. 1. **Incorrect :** As per section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

2. **Incorrect:** Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on - whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement.

Q-64 State the auditor's reporting responsibilities under CARO 2016 when –

(i) The company has raised money by public issue.

(ii) The company has made private placement of shares.

Ans. **Auditor's reporting responsibilities under CARO 2016:**

(i) **Clause (ix) para 3 of CARO, 2016 states** - whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

(ii) **Clause (xiv) para 3 of CARO, 2016 states** - whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance.

Q-65 CA G was appointed as the auditor of RJ Ltd. at the remuneration of INR 35000. He resigned after 7 months on health grounds but failed to file the required statement with the Registrar of Companies. What are the responsibilities of CA G as per section 140(2) of the Companies Act, 2013? As per section 140(3) of the Companies Act, 2013, how much fine will be levied on CA G for non-compliance of Sec 140(2) of the Companies Act 2013?

Ans. Casual Vacancy by Resignation:

As per section 140(2) of the Act, the auditor CA G who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT–3 (as per Rule 8 of CAAR) with the company and the Registrar.

The auditor shall indicate the reasons and other facts as may be relevant with regard to his resignation.

In the given case, CA G, auditor of RJ Ltd resigned after 7 months on health grounds and also, he did not file ADT-3 with the Registrar. So, he did not fulfil his responsibilities as stated under Section 140(2).

So, the auditor CA G shall be liable to a penalty of fifty thousand rupees or the remuneration of the auditor Rs 35000, whichever is less i.e., ` 35000, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of Two lakh rupees as persection 140(3).

Q-66 As per Sec 143(3)(j) of the Companies Act, 2013, the auditor's report shall also include such other matters as may be prescribed by Rule 11 of the Companies (Audit and Auditors) Rule, 2014. Discuss those matters on which views and comments of the auditor are required.

Ans. Others Matters prescribed by Rule 11 to include in Auditor's Report:

As per **section 143(3)(j)-** the auditor's report shall also state such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(iv) (1) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(2) Whether the management has represented, that, to the best of it's knowledge and belief, other

than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including oreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(3) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(iv) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

Q-67 CA R is the statutory auditor and Mr. P is the cost auditor of DEF Ltd., a company engaged in the production of tyres. Mr. P noticed a fraud of INR 1.25 crores done by the senior manager of the company and immediately informed the audit committee even before CA R was aware of the fraud. State the duty of CA R under section 143(12) of the Companies Act on reporting on frauds already detected and reported.

Ans. **Reporting on Frauds already detected and reported:**

The auditor, CA R should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis -à- vis those identified/detected by the company through its internal control mechanism.

Since reporting on fraud under section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud.

Here too, if a suspected offence of fraud has already been reported under section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same since he has not per se identified the suspected offence of fraud.

However, in case of a fraud which involves or is expected to involve individually, an amount of ` 1 crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence of fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/ those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed. If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

Q-68 Examine with reasons (in short) whether the following statements are correct or incorrect :

An auditor has to report on the matters specified in section 143(1) of the Companies Act, 2013.

Ans. **Incorrect:** The auditor is not required to report on the matters specified in section 143(1) of the Companies Act, 2013 unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. However, the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

Q-69 Discuss the provisions regarding appointment of First auditors of a Government company and a Non-Government company.

Ans. Appointment of First Auditor of a Government Company: Section 139(7) of the Companies Act, 2013 provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor -General of India within 60 days from the date of registration of the company.

In case the Comptroller and Auditor-General of India does not appoint such auditor within the above said period, the Board of Directors of the company shall appoint such auditor within the next 30 days. Further, in the case of failure of the Board to appoint such auditor within next 30 days, it shall inform the members of the company who shall appoint such auditor within 60 days at an extraordinary general meeting. Auditors shall hold office till the conclusion of the first annual general meeting.

Appointment of First Auditor of a Non-Government Company: As per Section 139(6) of the Companies Act, 2013, the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within 30 days from the date of registration of the company.

In the case of failure of the Board to appoint the auditor, it shall inform the members of the company.

The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor. Appointed auditor shall hold office till the conclusion of the first annual general meeting.

Q-70 State the matters to be included in auditor's report as per CARO, 2020 regarding “Default in repayment of loan or borrowing to a financial institution, bank etc.”

Ans.(a) The auditor is required to report as per clause (ix) of paragraph 3 of CARO 2020

(a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	Name of lender	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
	lender wise details to be provided in case of defaults to banks, financial institutions and Government.				

(b) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;

(c) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

(d) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;

(e) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;

(f) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also repor if the company has defaulted in repayment of such loans raised;

Q-71 Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him. Explain along with relevant rule of The Companies (Audit and Auditors) Rules, 2014

Ans. Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11).

Further, auditor has to report whether to best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and following matters as prescribed under relevant rules (Rule 11):-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(iv) (1) Whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(2) Whether the management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(3) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(v) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013

Q-72 Examine with reasons (in short) whether the following statements are correct or incorrect :

1. If auditor purchased goods on credit from the company and company allowed auditor a period of credit, this does not disqualify him to be an auditor.

2. The term “relative”, as defined under the Companies Act, 2013, means anyone who is closely related to another.

Ans. **Incorrect**: Where an auditor purchases goods or services from a company audited by him on credit he is definitely indebted to the company and if at any point of time, the amount outstanding exceeds upees five lakh he is disqualified for appointment as an auditor of the company and has to vacate his office. It will not make any difference if the company allows him the period of credit as it allows to other customers in the normal business. He, in fact, in such a case also has become indebted to the company and consequently has to vacate his office.

Incorrect: The term “relative”, as defined under the Companies Act, 2013, means anyone who is related to another as members of a Hindu Undivided Family; husband and wife; Father (including step- father), Mother (including step-mother), Son (including step- son), Son’s wife, Daughter, Daughter’s husband, Brother (including step- brother), Sister (including step-sister).

Q-73 XYZ Limited is engaged in the business of Shoes having geographical presence across India. Following details are available from the last audited financial statements of XYZ Limited for the financial year 2020-21 :

Particulars	₹
Paid-up Capital as on 31st March 2021	9.8 Crores
Turnover for Financial Year 2020-21	98 Crores
Outstanding Loan from Bank as on 31st March 2021	25 Crores
Liability on Outstanding Debentures as on 31st March 2021	26 Crores

Comment on the applicability of constitution of Audit Committee for XYZ Limited for the financial year 2021-22 based on the above information.

Ans. Applicability of Constitution of Audit Committee: According to Section 177 of the Companies Act, 2013, in addition to listed public companies, following classes of companies shall con stitute and Audit Committee -

(i) All public companies with a paid-up capital of ten crore rupees or more;

(ii) All public companies having turnover of one hundred crore rupees or more;

(iii) All public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation- The paid-up share capital or turnover or outstanding loans or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule. Therefore, provisions of constitution of audit committee are applicable only to listed companies and public companies satisfying criteria as stated above.

In the given case, XYZ Limited, engaged in the business of Shoes, is a public company and it’s having paid-up capital of 9.8 crore rupees and turnover of 98 crore which is less than prescribed limit (i.e., 10 crores for paid-up capital and 100 crores for turnover). However, aggregate of its outstanding loan from bank (25 crores) and liability on outstanding debentures (26 crore) is exceeding the prescribed limit i.e., 50 crore rupees. Therefore, provisions relating to constitution of Audit Committee will be applicable for XYZ Limited.

Q-74 Section 147 of the Companies Act, 2013 prescribes punishments for contraventions by the Company, its officers and auditors. Explain the provisions of Section 147 of the Companies Act, 2013.

Ans. Section 147 of the Companies Act, 2013 prescribes following punishments for contravention:

(1) If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees, but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than ten thousand rupees, but which may extend to one lakh rupees.

(2) If an auditor of a company contravenes any of the provisions of section 139, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty -five thousand rupees, but which may extend to five lakh rupees or four times the remuneration of the auditor, whichever is less.

It may be noted that if an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees or eight times the remuneration of the auditor, whichever is less.

(3) Where an auditor has been convicted under sub-section (2), he shall be liable to: -

(i) refund the remuneration received by him to the company.

(ii) and pay for damages to the company statutory bodies or authorities or to members or the creditors of the Company for loss arising out of incorrect or misleading statements of particulars made in his audit report.

(4) The Central Government shall, by notification, specify any statutory body or authority of an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

(5) Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in a fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil criminal as provided in this Act or in any other law for the time being in force, for such act shall be the partner or partners concerned of the audit firm and of the firm jointly and severally. However, in case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.

Q-75 State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits.

Ans. **Matters to be included in Auditor's report as per CARO 2020:**

(i) Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

(a) whether physical verification of inventory has been conducted at reasonable intervals by **the management and whether, in the opinion of the auditor, the coverage and procedure** of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

(b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

MULTIPLE CHOICE QUESTIONS

1. Under sub-section (3) of section 141 along with Rule 10 of the Companies (Audit and Auditors) Rules,2014 (hereinafter referred as CAAR), the following persons shall not be eligible for appointment as anauditor of a company, namely-

(i) a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(ii) an officer or employee of the company;

(iii) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(iv) a person who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. It may be noted that the relative may hold security or interest in the company of face value not exceeding Rs. 1,00,000.

Which of the above is incorrect :

(a) All statements are incorrect.
(b) (i) and (ii)
(c) (i) only
(d) (iv) only

2. Which of the following is not an advantage of Joint Äudit :

(a) Sharing of expertise
(b) General superiority complexes of some auditors.
(c) Lower workload.
(d) Displacement of the auditor of the company taken over in a take - over often obviated.

3. Which of the following is correct as per section 143(10) of the Companies Act, 2013 :

(a) IFAC may prescribe the standards of auditing as recommended by the Institute of CharteredAccountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(b) The International Auditing Standards Board may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(c) the MCA may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(d) the Central Government may prescribe the standards of auditing as recommended by the Instituteof Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

4. Which of the following is not a duty of auditor to report under section 143 (1)

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

5. **Section 139(7)** provides that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India ___________from the date of registration of the company.

   (a) within 60 days (b) within 30 days (c) within 90 days (d) within 45 days

6. As per **Section 139(8),** any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India,

   (a) be filled by the Audit committee within 60 days.

   (b) be filled by the Audit committee within 30 days.

   (c) be filled by the Board of Directors within 60 days.

   (d) be filled by the Board of Directors within 30 days.

7. As per section 140(2) the auditor who has resigned from the company shall-

   (a) file within a period of 60 days from the date of resignation, a statement in the prescribed Form ADT–3 (as per Rule 8 of CAAR) with the company and the Registrar

   (b) file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT–3 (as per Rule 8 of CAAR) with the company and the Registrar

   (c) file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT–3 (as per Rule 8 of CAAR) with the company.

   (d) file within a period of 60 days from the date of resignation, a statement in the prescribed Form ADT–3 (as per Rule 8 of CAAR) with the company.

8. Which of the following is correct :

   (a) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.

   (b) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its general meeting.

   (c) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its extra ordinary general meeting.

   (d) As per section 142 of the Act, the remuneration of the auditor of a company shall be fixed in its Board meeting or in such manner as may be determined therein.

9. Which of the following is incorrect :

   (a) According to Section 140(1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per Rule 7 of CAAR, 2014-

   (b) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

   (c) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.

   (d) The company shall hold the general meeting within 30 days of receipt of approval of the Central Government for passing the special resolution.

10. Which of the following is correct :

(a) A firm whereof all the partners practising anywhere are qualified for appointment may be appointed by its firm name to be auditor of a company.

(b) A firm whereof majority of partners practising anywhere are qualified for appointment may be appointed by its firm name to be auditor of a company.

(c) A firm whereof all the partners practising in India are qualified for appointment may be appointed by its firm name to be auditor of a company.

(d) A firm whereof majority of partners practising in India are qualified for appointment may be appointed by its firm name to be auditor of a company.

11. As per **Section 139(6),** the first auditor of a company, other than a Government company, shall be appointed

(a) by the Board of Directors within 30 days from the date of registration of the company.

(b) by the audit committee within 30 days from the date of registration of the company.

(c) by the Managing Director within 30 days from the date of registration of the company.

(d) by the shareholders within 30 days from the date of registration of the company.

12. Where a company is required to constitute an Audit Committee under section 177,

(a) all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

(b) all appointments, excluding the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

(c) appointment of first auditors shall be made after taking into account the recommendations of such committee.

(d) appointment of subsequent auditors shall be made after taking into account the recommendations of such committee.

13. Springfield Hospital located in the rural area of Lonawala region is a government hospital run by the local doctors who are appointed by the government. The hospital was registered on 1 October 2018. Which of the following is correct in respect of the appointment of the first auditor for Springfield Hospital?

(a) The Board of Directors of the hospital have appointed the first auditor on 5th November 2018.

(b) The Comptroller Auditor-General of India appointed the first auditor on 15th December 2018.

(c) Since the Comptroller Auditor-General of India did not appoint the first auditor, the Board of Director appointed the first auditor on 15th December 2018.

(d) Since the Comptroller Auditor-General of India did not appoint the first auditor, the Board of Director appointed the first auditor on 10th November 2018.

14. In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, __________, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

(a) the board (b) any director (c) Managing Director (d) Whole time director

15. Eeyore Pvt. Ltd. is incorporated on 1st July, 2017. During the Financial Year ending on 31st March, 2018, the company did not opt for any borrowing at any point of time and have a total revenue of ₹ 60 Lakh. At the year end, it provides the following information regarding its paid-up capital and reserve & surplus

Particulars	**Amount (in ₹)**
Paid-up Capital	
- Consideration received in cash for equity shares (including unpaid calls of ₹ 5,00,000)	40,00,000
- Consideration received in cash for preference shares	25,00,000
- Bonus shares allotted	7,00,000
- Share application money received pending allotment	10,00,000
Sub-Total	**82,00,000**
Reserve & Surplus	
- Balance in Statement of Profit and Loss	15,00,000
- Capital Reserves	10,00,000
Sub-Total	**25,00,000**
GRAND TOTAL	**1,07,00,000**

You are provided with the provisions regarding applicability of Companies (Auditor's Report) Order, 2016, (CARO, 2016) issued under section 143(11) of the Companies Act, 2013 to a private limited company that it specifically exempts a private limited company having a paid up capital and reserves and surplus not more than ₹1 crore as on the Balance Sheet date and which does not have total borrowings exceeding ₹ 1 crore from any bank 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, 2013 exceeding ₹ 10 crore during the financial year.

Considering the information given above, which of the following shall be considered as a reason regarding applicability or non-applicability of CARO, 2016?

(a) Reporting under CARO, 2016 shall be applicable as the company is having a paid up capital and reserves and surplus of ₹ 1.07 crore i.e. more than ₹ 1 crore as on the Balance Sheet date.

(b) Reporting under CARO, 2016 shall be applicable as the company is having a paid up capital and reserves and surplus of ₹ 1.02 crore i.e. more than ₹ 1 crore as on the Balance Sheet date.

(c) Reporting under CARO, 2016 shall not be applicable as the company is having a paid up capital and reserves and surplus of ₹ 0.92 crore i.e. not more than ₹ 1 crore as on the Balance Sheet date.

(d) Reporting under CARO, 2016 shall not be applicable as the company is having a paid up capital and reserves and surplus of ₹ 0.82 crore i.e. not more than ₹ 1 crore as on the Balance Sheet date.

16. CA. Daffy is the auditor of xBose Ltd. for the previous 2 years. However, due to certain unavoidable circumstances, no Annual General Meeting (AGM) was held for the current Financial Year ending on 31st March, 2018 within every possible time limit and thus, the ratification procedure for her appointment in the AGM could not be performed. Whether she may continue to hold the office of the auditor?

(a) CA. Daffy may continue to hold the office of the auditor for the current Financial Year only and thereafter shall resign herself as the ratification procedure could not be completed.

(b) CA. Daffy shall continue to hold the office of the auditor and ask the Board to re-appoint her in a private meeting.

(c) CA. Daffy shall continue to hold the office of the auditor as no such ratification provisions for appointment by members at every AGM exist.

(d) CA. Daffy shall not continue to hold office of the auditor as the ratification procedure could not be completed as per proviso to section 139(1) of the Companies Act, 2013.

Case Scenario 1

Integrated case study

Mr. Laxman is appointed as statutory auditor of Best Limited for the Financial Year ended 31st March, 2020. During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2020.

The fraud was going on since last 4-5 years and the total amount misappropriated is approximately ₹ 75 lacs.

Balance sheet of Best Ltd. reflected a cash balance of ₹ 7 crores. The company has taken a loan of ₹ 2 crores from the bank despite of the huge cash balance with the company.

Also, Companies Act bestows some duties on auditors to report matters to Central Government in case of fraud.

On the basis of above facts answer below questions in relation to Mr . Laxman's role and duties while conducting statutory audit of Best Limited.

1. As per Section 143 (12) of Companies Act, 2013 & Rule 13 of CAAR, 2014; Mr . Laxman shall

(a) **report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in** such manner as prescribed.

(b) report the matter to the audit committee constituted under section 177 within such time and in such manner as prescribed.

(c) report the matter to the audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed.

(d) report the matter to the Board within such time and in such manner as prescribed.

2. As an auditor what conclusion can Mr Laxman draw looking at the huge cash reserve of the company and corresponding bank loan?

(a) Report this matter to the Central Government u/s 143(12) as there is a possibility of fraud

(b) **Obtain sufficient and appropriate audit evidence of existence of fraud**

(c) Report the matter under CARO, 2020

(d) There is nothing to report as it's a normal financial decision .

❑

NOTES

CHAPTER-11

AUDIT REPORT

Q-1 The auditor shall evaluate whether the financial statements are prepared in accordanc e with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Advise about qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Ans. **Evaluations by the Auditor:** The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
   (i) The selective correction of misstatements brought to management's attention during theaudit

   Example
   - Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
   - The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction).

     This evaluation requires judgment and involvement of audit executives.

   (ii) Possible management bias in the making of accounting estimates.
4. SA 540 addresses possible management bias in making accounting estimates.Indicators of possible management bias do not constitute misstatements for purposes ofdrawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Q-2 The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain

Ans. **Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

(a) **Preparing the financial statements** in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

(b) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

Q-3 In order to form the audit opinion as required by SA 700, the auditor shall conclude as to whetherthe auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Explain the conclusions that the auditor shall take into account. Also explain the objective of auditor as per SA 700.

Ans. The objectives of the auditor as per SA 700 (Revised), "Forming An Opinion And Reporting On Financial Statements" are:

(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) To express clearly that opinion through a written report.

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

To form opinion - Auditor to obtain Reasonable assurance

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

(a) whether sufficient appropriate audit evidence has been obtained;

(b) whether uncorrected misstatements are material, individually or in aggregate;

(c) The evaluations

Q-4 When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in some circumstances. Explain those circumstances.

Ans. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances.

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

   (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

   (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.

3. Prior Period Financial Statements Not Audited- If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Q-5 Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.

Ans. **Communicating key audit matters in the auditor's report is not:**

(i) 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;

(ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(iv) A separate opinion on individual matters

Q-6 The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

Ans. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading **"Basis for Opinion"**, that:

(a) States that the audit was conducted in accordance with Standards on Auditing;

(b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Q-7 The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. Explain clearly stating the essential audit reporting differences between the approaches. Also define comparative information and audit procedures regarding comparative information.

Ans. **The nature of the comparative information** that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

(a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas

(b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Definition of Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Audit Procedures regarding comparative information

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

Q-8 Define Emphasis of Matter paragraph. When the auditor shall include an Emphasis of Matter paragraph in the auditor's report? Also explain how the auditor would include an Emphasis of Matter in the auditor's report?

Ans. **Emphasis of Matter paragraph –** A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

Separate section for Emphasis of Matter paragraph

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Q-9 Explain clearly the purpose of communicating key audit matters.

Ans. **Purpose of communicating key audit matters :** As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

Q-10 "An auditor is required to make specific evaluations while forming an opinion in an audit report." State them.

Ans. Specific Evaluations by the auditor: In particular, the auditor shall evaluate whether :

(i) The financial statements adequately disclose the significant accounting policies selected and applied;

(ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(iii) The accounting estimates made by management are reasonable;

(iv) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(v) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(vi) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Q-11 The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also Identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

Ans. The first section of the auditor's report shall include the auditor's opinion, and shall havethe heading "Opinion

"The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

Q-12 State clearly the objective of the Auditor as per SA 706. Also define emphasis of matter paragraph and other matter paragraph.

Ans. As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Q-13 Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Ans. Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disc losed in the financial statements; and

(iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Q-14 The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

Ans. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(a) States that the audit was conducted in accordance with Standards on Auditing;

(b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Q-15 In considering the qualitative aspects of the entity's accounting practices, the auditor may not become aware of possible bias in management's judgments.

Ans. **Incorrect:** In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Q-16 Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

Ans. **Examples of circumstances to include Emphasis of Matter Paragraph:** As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are;

(a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.

(b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

(c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.

(d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Q-17 "An auditor is required to make specific evaluations while forming an opinion in an audit report." State those specific evaluations.

Ans. **Specific Evaluations by the auditor:** The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

In particular, the auditor shall evaluate whether :

(i) The financial statements adequately disclose the significant accounting policies selected and applied;

(ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(iii) The accounting estimates made by management are reasonable;

(iv) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(v) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(vi) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Q-18 As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters".

Ans. **Determining Key Audit Matters:** As per SA 701, **"**Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

(ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(iii) The effect on the audit of significant events or transactions that occurred during the period.

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

Q-19 CA Guru is in the process of preparing the final audit report of JPA Private Limited and would like to disclaim his opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence. How CA Guru shall amend the description of the auditor's responsibilities as required by SA 700 (Revised)?

Ans. Since the auditor, CA Guru, disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence of JPA Pvt Ltd, the auditor (CA Guru) shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements , and

(c) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised)

Q-20 What an auditor should state in "Basis for opinion" section of auditor's report and when the auditor modifies the opinion on the financial statements, what amendments he should make in this section ?

Ans. An auditor should state in "Basis for Opinion" section of Auditor's Report as under:

Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading **"Basis for Opinion",** that:

(i) States that the audit was conducted in accordance with Standards on Auditing;

(ii) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(iii) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(i) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Amendments an Auditor should make :

When the auditor modifies the opinion on the financial statements, the auditor shall,

in addition to the specific elements required by SA 700 (Revised):

(i) Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and

(ii) Within this section, include a description of the matter giving rise to the modification.

Q-21 XYZ Ltd. which is in the business of trading of automobile components is following Cash Basis of Accounting for sale of spare parts. As Statutory Auditor of XYZ Ltd. explain the reporting requirements, manner of qualification and disclosure, if any, to be made in the auditor's report in line with AS-1 'Disclosure of Accounting Policies'.

Ans. Reporting requirements, Manner of qualification and disclosure to be made in the auditor's report in line with AS 1, "Disclosure of Accounting Policies" are given hereunder :

In the case of a company, members should qualify their audit reports in case –

(a) accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013 have not been disclosed, or

(b) accounts have not been prepared on accrual basis, or

(c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or

(d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the acc ounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.

In making a qualification / disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does notconstitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

Q-22 How would an auditor determine Key Audit Matters as per SA - 701, "Communicating Key Audit Matters in the Independent Auditor's Report"?

Ans. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit.

In making this determination, the auditor shall take into account the following:

(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA315.

(b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(c) The effect on the audit of significant events or transactions that occurred during the period.

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

Q-23 The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. Discuss the type of opinion that can be given and state giving reasoning.

Ans. Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.
2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
3. An unqualified opinion also indicates that:
   (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
   (ii) the financial statements comply with relevant statutory requirements and regulations; and
   (iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Q-24 The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain

Ans. The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Q-25 The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Explain stating clearly specific evaluations made by the auditor.

Ans. The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

In particular, the auditor shall evaluate whether:

(a) The financial statements adequately disclose the significant accounting policies selected and applied;

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

(a) The overall presentation, structure and content of the financial statements; and

(b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

Q-26 When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700. Explain

Ans. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

Q-27 M/s S & Associates are the Statutory Auditors of Real Ltd., a company engaged in the business of manufacturing of garments. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the F.Y. 2020-2021. CA K, the engagement partner, wants to conclude that whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. What factors he should consider to reach that conclusion?

Ans. **Factors to be considered to form an opinion:**

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

(a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained

(b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate.

(c) The evaluations required

  (i) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

  (ii) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Q-28 What are the circumstances in which auditors are required to qualify their reports of companies for mattes related to AS-I 'Disclosure of Accounting Policies'?

Ans. While discharging their attest function, the members of the Institute may keep the following in mind with regard to mandatory Accounting Standards. As per AS 1 - Disclosure of Accounting Policies, in the case of a company, members should qualify their audit reports in case:

(i) accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013, have not been disclosed, or

(ii) accounts have not been prepared on accrual basis, or

(iii) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or

(iv) proper disclosures regarding changes in the accounting policies have not been made.

Q-29 Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not considered as a substitute or alternative for a number of important items.

What are those items?

Ans. As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

(i) 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;

(ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report";

(iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(iv) A separate opinion on individual matters.

MULTIPLE CHOICE QUESTIONS

1. A company did not disclose accounting policies required to be disclosed under Schedule III or any otherprovisions of the Companies Act, 2013, the auditor should issue–

(a) a qualified opinion
(b) an adverse opinion
(c) a disclaimer of opinion
(d) emphasis of matter paragraph.

2. An Audit report is :

(a) an opinion drawn on the entity's financial statements to make sure that the records are true andcorrect representation of the transactions they claim to represent.

(b) an opinion drawn on the entity's books of accounts to make sure that the records are true and fair representation of the transactions they claim to represent.

(c) an opinion drawn on the entity's financial statements to make sure that the records are true andfair representation of the transactions they claim to represent.

(d) an opinion drawn on the entity's books of accounts to make sure that the records are true andcorrect representation of the transactions they claim to represent.

3. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances,

(a) the auditor shall express a qualified opinion in accordance with SA 705.

(b) the auditor shall express a disclaimer of opinion in accordance with SA 705.

(c) the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(d) the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

4. Which of the following is correct :

(a) The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(b) The auditor shall express a disclaimer opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(c) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(d) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements

5. Most of the auditor's work in forming the auditor's opinion consists of :

(a) obtaining audit evidence.
(b) evaluating audit evidence.
(c) obtaining or evaluating audit evidence.
(d) obtaining and evaluating audit evidence.

6. Which of the following is correct :

(a) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor need not disclose the substantive reasons for the different opinion.

(b) **When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.**

(c) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an emphasis of Matter paragraph in accordance with SA 706.

(d) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph or emphasis of matter paragraph in accordance with SA 706.

7. Which of the following is incorrect :

(a) Communicating key audit matters in the auditor's report 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;

(b) Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(c) Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;

(d) Communicating key audit matters in the auditor's report is a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

8. CA. Goofy has been appointed as an auditor for audit of a complete set of financial statements of Dippy Ltd., a listed company. The financial statements of the company are prepared by the management in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013. However, the inventories are misstated which is deemed to be material but not pervasive to the financial statements. Based on the audit evidences obtained, CA. Goofy has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570. Further, CA. Goofy is also aware of the fact that a qualified opinion would be appropriate due to a material misstatement of the Financial Statements. State what phrases should the auditor use while drafting such opinion paragraph?

(a) In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(b) In our opinion and to the best of our information and according to the explanations given to us, with the foregoing explanation, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(c) In our opinion and to the best of our information and according to the explanations given to us, subject to the misstatement regarding inventories, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(d) In our opinion and to the best of our information and according to the explanations given to us, with the explanation described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

9. Which of the following is not correct:

(a) SA 700- Forming an Opinion and Reporting on Financial Statements

(b) SA 705- Modified Opinion

(c) SA 701- Communicating Key Audit Matters

(d) SA 706-Comparative Information

❑

NOTES

CHAPTER-12

BANK AUDIT

Q-1 Your firm of Chartered Accountants has been appointed as the Auditor of two branches of OBC which are located in the Industrial area. Considering that the location of the branches of bank in industrial area, these would be “advances oriented branches and audit of advances would require the major attention of the auditors. Advise how would you proceed to obtain evidence in respect of audit of advances.

Ans. **Audit of Advances:** Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.

b. Advances represent amount due to the bank.

c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

d. There are no unrecorded advances.

e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.

f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- examining the validity of the recorded amounts;
- examining loan documentation;
- reviewing the operation of the accounts;
- examining the existence, enforceability and valuation of the security;
- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Q-2 The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

Analyse and Advise the matters to be discussed in the engagement team discussion.

Ans. The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:

- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
- An opportunity for engagement team members to exchange information about the bank's business risks.
- An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements.

These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

Errors that may be more likely to occur;

Errors which have been identified in prior years;

Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

Need to maintain professional skepticism throughout the audit engagement;

Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Q-3 The auditor should examine the efficacy of various internal controls over advances in case of Banks to determine the nature, timing and extent of his substantive procedures. Explain what is included in the internal controls over advances.

Ans. **Evaluation of Internal Controls over Advances:** The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, *inter alia*, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.

- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year, and at more frequent intervals in the case of large advances.

Q-4 "Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose."

Now he needs your assistance on the following points so as to incorporate them in the audit plan:

(i) for determination of NPA norms for agricultural advances

(ii) for accounts where there is erosion in the value of security/frauds committed by the borrowers.

Ans.(i) NPA norms for Agricultural Advances: As per the guidelines, Agricultural Advances are of two types, (1) Agricultural Advances for "long duration" crops and (2) Agricultural Advances for "short duration" crops The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and,
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

(ii) Accounts where there is erosion in the value of security / frauds committed by borrowers

Not prudent to follow stages of asset classification. It should be straightaway classified as doubtful or loss asset as appropriate.

(i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

Q-5 At the AGM of HDB Pvt. Ltd., Mr. R was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to pursue his career in banking sector. The Board of Director has appointed Mr. L as the statutory auditor in board meeting within 30 days. Comment on the matter with reference to the provisions of Companies Act, 2013.

Ans. **Casual Vacancy by Resignation:** As per Section 139(8), any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days. If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

Further, as per section 140(2) the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar. In the instant case, R resigned after three months of his appointment as statutory auditor as he wanted to pursue his career in banking sector.

Therefore, the board of director has appointed Mr. L as the statutory auditor with in 30 days is in order subject to such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board. Further, it is also the duty of the auditor to file, within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar in compliance with section 140(2) of the Companies Act, 2013.

Q-6 Mr. A approaches a bank for financial assistance for his upcoming project. The Bank Branch Manager, after verifying the proposal, is agreeable to financing Mr. A, but asks for the security to be offered to the bank. Discuss the nature of securities required to be offered to the bank.

Ans. **Nature of Security :**

I. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

II. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following.

- Personal Security of Guarantor
- Goods / Stocks / Debtors / Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

Q-7 In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain.

Ans. **Reversal of Income:**

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

Q-8 "There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured." Critically evaluate the statement on the basis of provisioning norms of NPA of nationalised bank.

Ans. **Classification as NPA** should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Sub-standards assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:	**Provision required**	
• Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%	
• Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured	
• **Sub-categories**:		
Doubtful up to 1 Year (D1)	25%	+ 100%
Doubtful 1 to 3 Years (D2)	40%	+ 100%
Doubtful more than 3 Years (D3)	100%	+ 100%
• Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%	

Q-9 Your firm of Chartered Accountants has been appointed as auditor of a Nationalised bank. Explain how will you proceed to carry out audit of provisions and contingencies.

Ans. **For audit of Provisions and contingencies**, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled. The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub -standard, doubtful, loss and nonperforming assets. The auditor may verify the loan classification on a sample basis.

The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger . The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The other provisions for expenses should be examined vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Q-10 Distinguish between Primary Security and Collateral Security with reference to audit of Banks. Also give examples of most common types of securities accepted by the Banks.

Ans. **A. Primary security** refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

Q-11 Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks.

Ans. Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

(i) Mortgage: Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

- Registered Mortgage can be affected by a registered instrument called the "Mortgage Deed" signed by the mortgagor. It registers the property to the mortgagee as a security.
- **Equitable mortgage**, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) Pledge: A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

(iii) Hypothecation: The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

(iv) Assignment: Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

(v) Set-off Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity.

The right of set-off can be exercised in respect of time-barred debts also.

(vi) Lien: Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

Q-12 In the case of a nationalised bank, the auditor is required to make a report to the Central Government. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

Explain what would the auditor state in his report.

Ans. In the case of a nationalised bank, the auditor is required to make a report to the Central Governmentin which he has to state the following:

(a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

Q-13 Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

Ans. **Advances under Consortium:** Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Q-14 In case of a Bank, explain the meaning of Funded loans. Also give examples.

Ans. **Funded** loans are those loans where there is an actual transfer of funds from the bank to the borrower.

Advances comprise of funded amounts by way of:

- Term loans :-
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

Q-15 "There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured." Critically evaluate the statement on the basis of provisioning norms of NPA of nationalised bank stating clearly the provision percent required.

Ans. Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Sub-standards assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:	Provision required
• **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months	15%
• **Doubtful Assets:**	
Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured
• **Sub-categories:**	
Doubtful up to 1 Year (D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	100% + 100%
• **Loss Assets:**	
Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Q-16 N Ltd. has been sanctioned a Cash Credit Facility by XYZ Bank Ltd. for INR 1 crore and drawing power as per the stock statements furnished for the last quarter is INR 80 Lakh. Outstanding balance in the account is INR 75 lakh. Interest charged to the account is INR 3.5 Lakh and total credit into the account for the quarter is INR 2.5 Lakh. As an auditor how will you report this account in your report.

Ans. **Out of Order:** 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, these accounts should be treated as 'out of order'.

Applying the above to the given case of N Ltd, its Drawing power is ₹ 80 Lakhs, although outstanding balance in the account is ₹ 75 Lakhs, but still the account would be reported as out of order because credits in the account are not sufficient to cover the interest debited during the same period.

Q-17 Discuss the advantages of engagement team discussion done at the planning stage of the bank audit.

Ans. **Advantages of engagement team discussion done at the planning stage of Bank audit are:**

- Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

Q-18 Your firm of auditors, SRG & Co., has been appointed as Statutory Central Auditors of Reliable Bank. Explain the reporting requirements of the Statutory Central Auditors (SCAs) in addition to their main audit report.

Ans. **Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:**

(a) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.

(b) Long Form Audit Report. (LFAR)

(c) Report on compliance with SLR requirements.

(d) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.

(e) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.

(f) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.

(g) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.

(h) Report on instances of adverse credit-deposit ratio in the rural areas.

Q-19 Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. Explain the broad considerations about which the auditor is primarily concerned with obtaining evidence in carrying out audit of advances.

Ans. Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

(a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.

(b) Advances represent amount due to the bank.

(c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.

(d) There are no unrecorded advances.

(e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.

(f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

(g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

Q-20 There are different provisioning requirements as regards to categories of NPA such as Sub-standards assets, Doubtful assets and loss assets. Explain in detail.

Ans. Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Sub-standards assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:

(i)	**Substandard Assets:**	**Provision required**		
	Would be one, which has remained NPA for a period less than or equal to 12 months.	15%		
(ii)	**Doubtful Assets:**			
	Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured		
(i)	**Sub-categories:**			
	Doubtful up to 1 Year (D1)	25%	+	100%
	Doubtful 1 to 3 Years (D2)	40%	+	100%
	Doubtful more than 3 Years (D3)	100%	+	100%

(ii) Loss Assets:

Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Q-21 Explain the following in the context of Bank audit:

(a) For audit of operating expenses, the auditor should study and evaluate the system of internal control relating to expenses.

(b) For audit of Provisions and contingencies, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.

Ans.(a) For audit of operating expenses, the auditor should study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures. The auditor should examine whether there are any divergent trends in respect of major items of expenses. The auditor should perform substantive analytical procedures in respect of these expenses. e.g. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years. The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

(b) For audit of Provisions and contingencies, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled. The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets.

It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.

The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger. The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The other provisions for expenses should be examined vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Q-22 In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit.

(i) Bank's Duties

(ii) Auditor's concern

(iii) Computation of DP

(iv) Stock audit

Ans. **Computation of Drawing Power:**

(i) **Bank's Duties:** Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

(ii) **Auditor's Concern:** The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

(iii) **Computation of DP:** It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

(iv) **Stock Audit:** The stock audit should be carried out by the bank for all accounts having funded exposure of more than I 5 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

Q-23 Explain the categories of Agricultural Advances in case of Banks and related NPA norms.

Ans. **As per the guidelines, Agricultural Advances are of two types:**

(1) Agricultural Advances for "long duration" crops; and

(2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or **interest thereon remains overdue for one crop season.**

Q-24 In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount. Explain the Audit Approach and Procedures regarding following points in the above context :

(i) RBI's Directions

(ii) Materiality

(iii) Revenue Certainty

(iv) Revenue Uncertainty

Ans. Audit Approach and Procedures

- Auditor's Concern: In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.
- RBI's Directions: RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.
- Materiality: If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.
- Revenue Certainty: Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.
- Revenue Uncertainty: In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is correct :

(a) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheetand profit and loss account of a banking company should be audited by a Firm of Chartered Accountants only.

(b) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheetand profit and loss account of a banking company should be audited by a person duly qualifiedunder any law for the time being in force to be an auditor of companies.

(c) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheetand profit and loss account of a banking company should be audited by a CAG Auditor only.

(d) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheetand profit and loss account of a banking company should be audited by a by a person duly qualified under Banking Law.

2. Which of the following is correct in case of Banks :

(a) The policy of income recognition should be subjective.

(b) The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations.

(c) The policy of income recognition should be objective.

(d) The policy of income recognition may be objective or subjective.

3. You are at the planning stage for one of your firm's client XYZ Bank for the year ended 31 March 2018. The bank is a commercial bank that provides a number of products and services to the general public and other segments of the economy in the area of South Mumbai. You are assigned the audit of one of the branches of XYZ Bank. The audit engagement team was called to have a detailed discussion on the following matters. Which one of the following should not be included in the discussion for the audit of banks?

(a) Discuss on the error of last year in the application of accounting policies of the bank.

(b) Discuss on the method of fraud if any perpetrated by the bank employee within particular balances and/or disclosures

(c) Discuss with the team the appointment and remuneration to be received on this bank audit.

(d) Discuss the effect of the results of the risk assessment procedures on other aspects to decide the nature, timing and extent of further audit procedures.

4. A Ltd. has been assigned a Cash Credit limit of INR 20 lacs as against its Book Debts furnished as security. What kind of Security creation is it?

(a) Pledge (b) Mortgage **(c) Assignment** (d) Set-off

❑

CHAPTER-13

AUDIT OF DIFFERENT TYPES OF ENTITIES

Q-1 Audit against the propriety seeks to ensure that expenditure confirms to certain principles. Explain.

Ans. **Audit against propriety:** Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(1) The expenditure should not be *prima facie* more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(2) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(3) Public moneys should not be utilized for the benefit of a particular person or section of the community unless:

- (i) The amount of expenditure involved is insignificant; or
- (ii) A claim for the amount could be enforced in a Court of law; or
- (iii) The expenditure is in pursuance of a recognized policy or custom; and
- (iv) The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Q-2 The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital?

Ans. Special points of consideration while auditing certain transactions of a hospital are stated below-

(i) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verifybills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) **Collection of Cash**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(iii) **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(iv) **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(v) **Authorisation and Sanctions**: Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

Q-3 An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention two points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

Ans. **Receipt of Donations :**

(i) **Internal Control System:** Existence of internal control system particularly with reference todivision of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

(iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

(i) **Mode of Sending Remittance:** All remittances are through account payee cheques.Remittances through Demand Draft would also need to be scrutinised thoroughly withreference to recipient.

(ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.

(iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.

(v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and notfor any other purpose.

(vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

Q-4 Advise any six special points in an audit of hospital.

Ans. **Audit of Hospital:** The special steps involved in such an audit are stated below-

(1) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(2) **Collection of Cash**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(3) **Income from Investments, Rent etc**: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.

(4) **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(5) **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(6) **Authorisation and Sanctions**: Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(7) **Grants and TDS**: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(8) **Budgets**: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

(9) **Internal Check**: Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

(10) **Depreciation**: See that depreciation has been written off against all the assets at the appropriate rates.

(11) **Registers**: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(12) **Inventories**: Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

(13) **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Q-5 Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountantwithin the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor ofMulti-State co-operative society. Explain stating also the persons who are not eligible for appointment as auditors of a Multi-State co-operative society.

Ans. Qualification of Auditors - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However, the following persons are not eligible 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 the 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.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

Q-6 BPL Ltd. is running a "RAGHU PALACE CINEMA." Your firm of Chartered Accountants has beenappointed to get its accounts audited. Assistant appointed on the job to conduct audit asks theaudit in charge as to how to go about conducting an audit and seeks your guidance on it. Keepingin view the above you are required to explain to the assistant special steps (any five) involved in the Audit of Cinema.

Ans. The special steps involved in the audit of Cinema are stated below-

(1) Verify the internal control mechanism-

(a) that entrance to the cinema-hall during show is only through printed tickets;

(b) that they are serially numbered and bound into books;

(c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(d) that for advance booking a separate series of tickets is issued; and

(e) that the inventory of tickets is kept in the custody of a responsible official.

(2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(4) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class and vouch and verify the entertainment tax returns filed each month.

(5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.

(7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.

(8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.

(9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

(11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

Q-7 Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards.

Ans. **Government Expenditure Audit:** Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. **Briefly, these standards are explained below:**

(i) **Audit against Rules & Orders:** The auditor has to see that the expenditureincurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.

(iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cumperformance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Q-8 Explain in detail the duties of Comptroller and Auditor General of India.

Ans. **Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and** Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

(i) **Compile and submit Accounts of Union and States -** The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relatingto Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure -** Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) **Audit of Grants or Loans -** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptrollerand Auditor General to audit all receipts which are payable into the Consolidated

Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory -** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations -** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

The comptroller and Auditor -

General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Q-9 What are the special steps involved in conducting the audit of an Educational Institution?

Ans. The Special Steps Involved in the Audit of an Educational Institution are the following:

(i) Examine the Trust Deed, or Regulations in the case of school or college and note allthe provisions affecting accounts. In the case of a university, refer to the Act ofLegislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

Q-10 Discuss the matters which should be specially considered in the audit of accounts of a partnership.

Ans. **Matters which should be specially considered in the audit of accounts of a partnership:**

(i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

(ii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.

(iii) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

(iv) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

(v) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.

(vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

(vii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

Q-11 You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?

Ans. While planning the audit of an NGO, the auditor may concentrate on the following:

(i) Knowledge of the NGO's work, its mission and vision, areas of operations andenvironment in which it operate.

(ii) Updating knowledge of relevant statutes especially with regard to recentamendments, circulars, judicial decisions related to the statutes.

(iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(vii) Setting of materiality levels for audit purposes.

(viii) The nature and timing of reports or other communications.

(ix) The involvement of experts and their reports.

(x) Review the previous year's Audit Report.

Q-12 Define the different types of lease agreements as per Accounting Standard/Ind-AS.

Ans. AS-19/ Ind-AS 17 defines that lease arrangements could be of 2 types i.e.

(i) Finance Lease and

(ii) Operating Lease.

Finance Lease**:** An arrangement with the following attributes qualifies as a Finance Lease:

The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialized nature that only the lessee can use them without major modifications Operating Lease.

  An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

Q-13 Central Govt. hold 55% of the paid up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co-operative Society Act.

Ans. Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi -State co-operative society. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

i. that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or

ii. that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or

iii. that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co- operative society is in danger, Central government can direct for special audit.

Q-14 Discuss the power of C & AG in Government audit.

Ans. Powers of C&AG

The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

i. To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

ii. To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

iii. To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

iv. In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

Q-15 "While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel but for other expenses, an auditor generally prefers to verify other attributes." Mention those attributes.

Ans. **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 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.

Q-16 Mr. M, has served as an auditor in the Co-Operative Department of a Government, is appointed as a statutory auditor by a Co-Operative Society that has receipts over ₹3 crores during the financial year. He is not a Chartered Accountant. Mr. D, Chartered Accountant is appointed to conduct tax audit of the society under section 44AB of the Income Tax Act, 1961. Comment.

Ans. **Qualifications and Appointment of Auditors -** Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society.

Thus, in view of above provisions, appointment of Mr. M as statutory auditor and Mr. D as tax auditor under Section 44 AB is in order.

Q-17 State the objectives of audit of Local Bodies.

Ans. **Objective of Audit of Local Bodies:** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

(i) reporting on the fairness of the content and presentation of financial statements;

(ii) reporting upon the strengths and weaknesses of systems of financial control;

(iii) reporting on the adherence to legal and/or administrative requirements;

(iv) reporting upon whether value is being fully received on money spent; and

(v) detection and prevention of error, fraud and misuse of resources.

Q-18 (a) As per Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account. Explain

(b) Explain the powers and duties of auditors under the Multi-State Co-operative Societies Act, 2002.

Ans.(a) As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

(a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and

(b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:

 (i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.

 (ii) Whether, in his opinion, proper books of account have been kept by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.

 (iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

 (iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

(b) Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

(a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,

(b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,

(c) Whether personal expenses have been charged to revenue account, and

(d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

Q-19 In the case of audit of a charitable institution, what attentions should be paid by the auditor regarding audit of expenditure items?

Ans. Audit of Expenditure of Charitable Institution:

(i) Vouching payment of grants also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the management committee has benefited there from either directly or indirectly.

(ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.

(iii) Check payment along with supporting documents in regard to salary and other expenses. Verify that all payments are made after proper sanction by appropriate authority.

(iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

(v) Verifying the cash and bank balances/payments.

Q-20 You have been appointed auditor of M/s. Divine Children Hospital. Discuss any four important points that would attract your attention while audit.

Ans. Audit of Hospital

The important points involved in such an audit are stated below-

(i) **Register of patients**: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) **Collection of Cash**: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For eg. copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills etc.

(iii) **Income from Investments, Rent etc.**: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends and interest on securities have been collected.

(iv) **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) **Authorisation and sanctions**: Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) **Grants and TDS**: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(viii) **Budgets**: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

(ix) **Internal Check**: Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

(x) **Depreciation**: See that depreciation has been written off against all the assets at the appropriate rates.

(xi) **Registers**: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) **Inventories**: Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.

(xiii) **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Q-21 The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. Explain.

Ans. **Compile and submit Accounts of Union and States -** The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

Q-22 Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. Analyse and Explain.

Ans. **Audit against Rules & Orders -** Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

(i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

(ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and

(iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes , rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

Q-23 The auditor of a Govt Company has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. Explain.

Ans. **Audit of sanctions -** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

Q-24 The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India.

Ans. **Incorrect:** The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.

Q-25 What is the function of audit while examining various rules, regulations and orders with regard Audit against Rules & Orders by C&AG?

Ans. Audit against Rules & Orders – Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made there under. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(a) they are not inconsistent with any provisions of the Constitution or any laws made there under;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Q-26 List out the types of Revenue Grants received by local bodies from the State.

Ans. **Revenue grants received by Local Bodies:**

Local bodies may receive different types of grants from the state administration. Broadly the revenue grants are of three types:

(1) General purpose grants: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(2) Specific purpose grants: These grants which are tied to the provision of certain services or performance of certain tasks.

(3) Statutory and compensatory grants: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

Q-27 PQR Ltd., a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in the infructuous expenditure.

Considering the above case, explain the type of expenditure audit to be performed to curb the situation.

Ans. **Propriety audit:** According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Further, it may so happen that a transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

In the given situation, PQR Ltd. being a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in an infructuous expenditure.

Thus, propriety audit should be done for PQR Ltd. to bring out improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations to the notice of the proper authorities of wastefulness in public administration.

Q-28 Discuss the following: The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 provides certain powers to the C & AG in connection with performance of his duties. Discuss.

Ans. Powers of C & AG in performance of his duties: The Comptroller and Auditor General's (Duties, Powers and Condition of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties:

(i) To inspect any an office accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.

(ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(iii) To put such questions or make such observations as he may consider necessary to the person- in charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine.

Q-29 You have been appointed auditor of Dr. Prem Ratan Hospital. Discuss any eight important points that would attract your attention while audit.

Ans. **AUDIT OF HOSPITAL**

The important points involved in such an audit are stated below-

(i) **Register of patients**: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) Collection of Cash: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For eg. copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills etc.

(iii) Income from Investments, Rent etc.: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends and interest on securities have been collected.

(iv) Legacies and Donations: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) Reconciliation of Subscriptions: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) Authorisation and sanctions: Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) Grants and TDS: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(viii) Budgets: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

(ix) Internal Check: Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

(x) Depreciation: See that depreciation has been written off against all the assets at the appropriate rates.

(xi) Registers: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) Inventories: Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.

(xiii) Management Representation and Certificate: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Q-30 "Public moneys should not be utilised for the benefit of a particular person or section of the community". List out the exceptions to this rule while audit against propriety.

Ans. **Exceptions to the rule – Audit Against Propriety:** Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Q-31 You have been appointed as an auditor of a health care service provider. Briefly discuss the special points that should be kept in mind as an auditor for developing an audit programme.

Ans. The special points to be kept in mind as an auditor for developing an audit programme of healthcare service provider are:

1. **Register of Patients:** Auditors to **v**ouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. **Collection of Cash**: Auditor to check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
3. **Income from Investments, Rent etc**: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.
4. **Legacies and Donations**: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
5. **Reconciliation of Subscriptions**: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
6. **Authorisation and Sanctions**: Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
7. **Grants and TDS**: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
8. **Budgets**: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
9. **Internal Check**: Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
10. **Depreciation**: See that depreciation has been written off against all the assets at the appropriate rates.
11. **Registers**: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
12. **Inventories**: Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
13. **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Alternative Answer

(b) Developing the Audit Programme

1. **Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
2. **Audit Objective and Instruction to Assistants:** The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
3. **Reliance on Internal Controls:** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.
4. **Timings of Performance of Audit Procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.
5. **Audit Planning:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

Q-32 Define Government Audit and explain its objectives.

Ans. **Government auditing is**

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES of Govt Audit are:

(a) **Accounting for Public Funds:** Government audit serves as a mechanism or process for public accounting of government funds.

(b) **Appraisal of Government policies:** It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(c) **Base for Corrective actions:** Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

(d) **Administrative Accountability:** The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.

Q-33 You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools.

Ans. **Verification of Assets & Liabilities of VJM Schools:**

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet and not transferred to revenue, unless they are not refundable.
3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
4. Ascertain that the system ordering inspection on receipt and issue of provisions, food stuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
5. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Q-34 Tomo Construction Engineering LLP approached CA K to understand various returns to be maintained and filed by them. Guide/Discuss the various returns to be maintained and filed by them.

Ans. Returns to be maintained and filed by an LLP:

- Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months or the financial year to which the Statement of Account and Solvency relates.

Q-35 As an Auditor of NGO, how do you check/verify atleast four receipts of income during the year?

Ans. The receipt of income of NGO may be checked on the following lines:

(i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for.

Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees.

Reconcile fees received with fees to be received during the year.

(iv) **Subscriptions:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/ circulars/periodicals. Check the receipts with subscription rate schedule.

(v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Q-36 You have been appointed as internal auditor of 'City Club' in Delhi. The receipts of the club were 50 lakhs during the previous year ending 2019-20. You are required to mention special points of consideration while auditing such receipts of the club.

Ans. The special steps involved, to be considered by the Internal Auditor of City Club in conducting the audit of receipts of the club are stated below-

(1) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.

(2) Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

(3) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance havebeen correctly adjusted.

(4) Check totals of various columns of the Register of members and tally them across.

(5) See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.

(6) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

Q-37 You are appointed as an auditor of co-operative society. State the special features of the co-operative audit to be borne in mind by the auditor, concerning:

(1) Audit classification of society.

(2) Discussion of draft audit report with the management committee.

Ans.(1) **Audit classification of society** - After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

(2) **Discussion of draft audit report with managing committee** – On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee.

Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

Q-38 The audit of receipts of government is not as old as audit of expenditure but with the rapid growth of public enterprises audit of receipts tax or non-tax has come to stay.

Discuss audit of receipts with respect to Government Audit.

Ans. Government auditing in India as elsewhere was primarily expenditure- oriented.

Gradually, audit of receipts-tax and non-tax was taken up.

The audit of receipts is neither all pervasive nor as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

(i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;

(ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

(iii) whether such regulations and procedures are actually being carried out;

(iv) whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds; and

(v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement.

The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. Are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

(vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned.

The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review ,in-depth study of specified areas, etc .as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period.

(vii) Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built –in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed.

(viii) The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

Q-39 Explain the different types of revenue grants which local bodies may receive.

Ans. Local bodies may receive different types of grants from the state administration as well.

Broadly, the revenue grants are of three categories:

(a) General purpose grants: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(b) Specific purpose grants: These grants which are tied to the provision of certain services or performance of certain tasks.

(c) Statutory and compensatory grants: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

Q-40 Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit.

Ans. Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES :-

(a) Accounting for Public Funds:-Government audit serves as a mechanism or process for public accounting of government funds.

(b) Appraisal of Government policies:-It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(c) Base for Corrective actions:-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

Q-41 Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. Explain

Ans. Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the **Comptroller and Auditor General** through the agency of the **Indian Audit and Accounts Department**. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

Q-42 Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. Explain.

Ans. Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

Q-43 No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society.

Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section.

Ans. Inspection of Multi-State Co-operative societies under Section 79

1. **When:** The Central Registrar may, on a request from
   (i) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or
   (ii) not less than one-third of the members of the board or
   (iii) not less than one-fifth of the total number of members of a Multi-State co-operative society
2. **How:** By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society.
3. **Opportunity of Being heard:** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.
4. **Powers available:** The Central Registrar or the person authorized by him shall have the following powers:
   (a) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
   (b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.
5. **Inspection Report:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

Q-44 Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas?

Ans. Reporting areas in audit of Local Fund: The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.

The important objectives of audit are:

(a) reporting on the fairness of the content and presentation of financial statements;

(b) reporting upon the strengths and weaknesses of systems of financial control;

(c) reporting on the adherence to legal and/or administrative requirements;

(d) reporting upon whether value is being fully received on money spent; and

(e) detection and prevention of error, fraud and misuse of resources.

Q-45 In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG. **(3 Marks)**

Ans. **Audit of Accounts of Stores and Inventories in Government Companies:**

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted:-

(i) to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.

(ii) to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

(iii) to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

(iv) to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

(v) to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

Q-46 CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution.

Ans. Audit Procedure in audit of Subscriptions & donations:

Audit Procedure to be undertaken by CA A in respect of Subscriptions and donations received by a Charitable Institution is:

(i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(ii) Whether official receipts are issued;

- (a) confirming that adequate control is imposed over unused receipt books;
- (b) obtaining all receipt books covering the period under review;
- (c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;
- (d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
- (e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of

control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

(f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

Q-47 Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards.

Ans. Expenditure Audit: The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

(i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.

(ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.

(iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.

(iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.

(v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

Q-48 You have been appointed auditor of M/s. BLK Hospital. Discuss important points that would attract your attention while audit.

Ans. **AUDIT OF HOSPITAL**

The important points involved in such an audit are stated below-

(i) Register of patients: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(ii) Collection of Cash: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For eg. copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills etc.

(iii) Income from Investments, Rent etc.: See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends and interest on securities have been collected.

(iv) Legacies and Donations: Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(v) Reconciliation of Subscriptions: Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(vi) Authorisation and sanctions: Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorised.

(vii) Grants and TDS: Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(viii) Budgets: Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

(ix) Internal Check: Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

(x) Depreciation: See that depreciation has been written off against all the assets at the appropriate rates.

(xi) Registers: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(xii) Inventories: Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.

(xiii) Management Representation and Certificate: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Q-49 Examine with reasons (in short) whether the following statements are correct or incorrect :

The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India.

Ans. **Incorrect:** The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.

Q-50 Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be.

Analyse and Explain

Ans. Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder.

It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

(i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

(ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and

(iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulat ions and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

OR

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit.

Ans. Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES :-

(a) Accounting for Public Funds:-Government audit serves as a mechanism or process for public accounting of government funds.

(b) Appraisal of Government policies:-It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(c) Base for Corrective actions:-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

Q-51 What are the special steps involved in conducting the audit of an Educational Institution? (Write any 12 points)

Ans. **The Special Steps Involved in the Audit of an Educational Institution are the following:**

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain t hat fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any

income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii)Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii)Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.

(xxiii)Confirm that the refund of taxes deducted from the income from investment (intere st on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv)Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is correct :

(a) Under section 128 of the Act, books of account of a company must be kept at the registered office.

(b) Under section 128 of the Act, books of account of a company must be kept at the corporate office

(c) Under section 128 of the Act, books of account of a company must be kept at the Head office ofthe company.

(d) Under section 128 of the Act, books of account of a company must be kept at the usual place of business.

2. In July, 2018, M/s Tom & Co. entered into an agreement with M/s Jerry & Co. under which a machinery would be let on hire and M/s Jerry & Co. would have the option to purchase the machinery in accordance with the terms of the agreement. Thus, M/s Jerry & Co. agreed to pay M/s Tom & Co. a settled amount in periodical instalments. The property in the goods shall be passed to M/s Jerry & Co. on the payment of last of such instalments. While checking such hire-purchase transaction, what would the auditor examine?

(a) That the periodical instalments paid are charged as an expenditure by M/s Jerry & Co.

(b) That the hire purchase agreement specifies clearly the hire-purchase price of the machinery to which the agreement relates.

(c) That M/s Tom & Co. charges depreciation throughout the life of the machinery.

(d) All of the above.

❑

NOTES

CHAPTER-14

CASE STUDY

Case Scenario 1

A Partnership Firm of Chartered Accountants by the name of HS and Associates was appointed to audit books of accounts of WT Limited for financial year 2019-20. HS and Associates consisted of two partners CA H and CA S.

While conducting audit of WT Limited for financial year 2019-20, CA H, one of the partners of HS and Associates used different audit procedures in order to obtain audit evidence.

The different audit procedures used by CA H were as follows:

(1) As WT Limited was engaged in manufacturing business of wooden doors, CA H and his team members carefully watched the whole process of counting of finished wooden doors by employees of WT Limited. The counting of finished wooden doors was necessary for the purpose of verification of stock of finished wooden doors.

(2) In WT Limited the stock of finished wooden doors was valued manually by multiplying number of finished wooden doors with value per finished wooden door. A team member of CA H again did the calculation in order to verify the accuracy regarding valuation of stock of wooden finished doors.

(3) CA H with the help of his team members obtained information from people (who were experienced in manufacturing business of wooden doors) about the purchase price of raw materials required in manufacturing business of wooden doors and also obtained some non-financial information.

(4) CA H and his team members while conducting the audit of WT Limited for financial year 2019-20 in detail checked and evaluated the books of accounts and relevant documents of W Limited.

(5) CA H asked for written confirmations regarding account balances from Debtors and Creditors of WT Limited.

Keeping the basic concepts about various audit procedures in mind, answer the following multiple-choice questions:

1. CA H and his team members carefully watched the whole process of counting of finished wooden doors by employees of WT Limited. This is an example of which audit procedure:

(a) External Confirmation. **(b) Observation.**

(c) Inquiry. (d) Inspection.

2. In order to verify the accuracy regarding valuation of stock of wooden finished doors, a team member of CA H again did the calculation. This is an example of which audit procedure:

(a) Analytical Procedures. (b) Inquiry.

(c) Inspection. **(d) Recalculation.**

3. CA H with the help of his team members obtained information (both financial and non-financial information) from experienced people in manufacturing business of wooden doors. These experienced people provided the required information. This whole method of obtaining information is an example of which audit procedure:

(a) Inspection
(b) Reperformance.
(c) Inquiry.
(d) Investigation.

4. CA H and his team members in detail checked and evaluated the books of accounts and relevant documents of WT Limited. This is an example of which audit procedure:

(a) Inspection.
(b) Reperformance.
(c) Recalculation.
(d) Investigation

5. Asking for written confirmations regarding account balances from Debtors and Creditors of WT Limited by CA H is an example of which audit procedure:

(a) Inquiry
(b) Inspection
(c) Investigation.
(d) External Confirmation.

Case Scenario 2

RM & Associates have been appointed as Auditors of Techblocks Consulting Ltd. for the year 2020-21. CA R and CA M were the Engagement partners.

Para 1

The Firm has freshly appointed 2 Article Clerks who had no practical knowledge in the area of Auditing. They had to work to tight hard-headed factual issues and were baffling to understand the various terms and their objectives in the field of Auditing.

Para 2

To make sure that the Article Clerk do not misplace or mis-handle the Working Papers, CA M also described the relevance of Audit File and clarified that working papers are the property of Auditor. Such Audit file should be preserved for a period of seven years.

Para 3

CA R while scrutinizing Books of Accounts suspected some fictitious sales as a result of which he anticipated inflated Debtors. Management was reluctant to give the details. As CA R could not gather more evidence from the Management, he sought to obtain details from the third party.

Para 4

On further perusal of Opening Balances, it is essential to perceive that Accounting Policies have been consistently applied in the current period's financial statements and whether any changes have been properly accounted for and disclosed. CA M assigned this duty to his article clerk. The Article clerk explained to CA M about how he had observed that Accounting policies were not consistently applied in relation to opening balances in accordance with the financial reporting framework or a change is not properly accounted or not adequately disclosed.

Para 5

Subsequently, the Auditors gathered from the Management that there was a fire in the Factory premises after the Balance Sheet date, as a result of which the company suffered loss of Inventories. It did not provide any conditions on the Balance Sheet date. SA 560 deals with such type of transactions.

1. The Auditor explained his Audit team the purpose of Audit Documentation. Which of the following is incorrect with respect to the purpose of Audit Documentation?

(a) It enables the conduct of quality control reviews and inspections in accordance with SQC-1.

(b) It helps in preparation of Financial Statements.

(c) It retains a record of matters of continuing significance to future audits.

(d) It enables the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

2. An auditor strictly ensured that the audit team should document / assemble all the working papers in Audit file. The completion of assembling the Audit File is an administrative process and should be done in :

(a) It should be within 30 days from the date of Audit Report.

(b) It should be within 60 days from the completion of Audit.

(c) It should not be more than 60 days from the date of Audit Report.

(d) It should be before 90 days from the completion of Audit.

3. With reference to para 3 of Case scenario, this is a case of obtaining External Confirmation by the Auditor. Which of the following is inappropriate with regard to External Confirmation?

(a) External Confirmations are restricted to Account balances only.

(b) It is also used in a case to obtain Audit evidence about the absence of certain conditions say, Side Agreement.

(c) It can be also effective in obtaining Audit evidence about verification of Inventories held by third parties at bonded warehouses for processing or on consignment.

(d) External Confirmation is also functional in case of Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the Balance Sheet date.

4. With reference to para 4, in such a situation CA M shall express a :

(a) A Disclaimer Opinion

(b) A qualified opinion

(c) A qualified opinion or an adverse opinion in accordance with SA 705

(d) An unmodified opinion

5. In respect to subject matter mentioned in Para 5, what procedures should Auditor perform to identify such events?

Statement 1: Obtain an understanding of any procedures management has established as well as Inquiry with Management and those charged with governance procedures for identification of such subsequent events.

Statement 2: Inspection of Minutes of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about the matters discussed at any such meetings for which minutes are not yet available.

Statement 3: The Auditor should not read the entity's latest subsequent interim financial statements, if any.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both Statements 1 and 2 are correct

(d) Only Statement 3 is correct

Case Scenario 3

Mars Ltd. is a public limited Company incorporated during the previous financial year 2019-20. R S Shah & Associates have been appointed as the Auditors of the Company.

Para 1

Its Authorized Capital was Rs. 75 Lacs. Subsequently it increased its Share Capital. They issued Shares at a premium of Rs.25/- per share. The Company has transferred the amount received as premium to the Securities Premium Account.

Para 2

CA R recommended his Engagement Team to prepare an Audit Strategy as well as Audit plan for efficient conduct of audit. He advised to the team that they should include a series of verification procedures to be applied to Financial Statements of the Company for accomplishing the Audit objectives. CA R illustrated to his team the relationship between Audit strategy as well as Audit plan.

Para 3

Encompassed by a huge clientele, one of the Auditee firm was a LLP. It was in the name of Mangaldeep Geotech LLP. They conducted the business in a very efficient way but had allotted only the Audit and the Income Tax work to CA R S Shah & Associates. The Partners of the LLP were capable enough but however inadvertently bypassed the ROC Compliances. They had no knowledge about the Compliances and its related penalties. Thus they approached CA R S Shah and Associates for their guidance. They were completely clueless as to filing of Annual Return with ROC.

Para 4

R S Shah and Associates have been appointed as Auditors of a large Enterprise namely Search Results Ltd. Considering the overhaul required in the Organization's Risk Management, Directors of the listed companies braced the subject of Internal Financial Control with much seriousness and rigor. The dawn of the Financial Year lays down the daunting task of establishing and implementing Internal Financial Control in an Enterprise.

Para 5

The Auditors are performing their Audit work in the Company Search Results Ltd by using CAAT's. The Company is completely automated and all the processes, operations are carried out using the Computer systems. Testing is performed in an automated environment to increase the efficiency and allow for more robust tools to be built. There are four types of testing methods in an Automated environment. They are Inquiry, Observation, Inspection and Re-performance.

1. Sec. 52 of the Companies Act states that Security Premium Account can be applied by the Company for one of the purpose mentioned below. Which of the following is an INCORRECT option?

(a) To write off preliminary expenses of the Company

(b) To pay dividend to equity shareholders

(c) To provide premium on redemption of Preference share capital

(d) To purchase its own shares or other securities under Sec 68(Buyback)

2. In reference to para 2, which of the following Statement is inappropriate?

(a) Once the overall audit strategy is established, an audit plan can be developed to address the various matters identified in the overall audit strategy.

(b) The establishment of overall audit strategy as well as detailed audit plan is a discrete and sequential process.

(c) Audit Strategy and Audit plan are inter-related as changes in one may result in consequential changes to the other.

(d) The Audit plan is more detailed than the Audit Strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members.

3. In reference to para 3, which form from the following should be filed by the Partners to avoid penalty consequences?

   (a) Form 11 within 90 day of end of closer of financial year and Form 8 within a period of 60 days from the end of six months of the financial year.

   (b) Form 11 within 60 days of end of closer of financial year and Form 8 within a period of 30 days from the end of six months of the financial year.

   (c) Form 11 within 30 days of end of closer of financial year and Form 8 within a period of 60 days from the end of three months of the financial year.

   (d) Form 11 within 60 day of end of closer of financial year and Form 8 within a period of 90 days from the end of three months of the financial year.

4. With reference to para 4, which of the following point ensures implementation of policies and procedures with regard to Internal Financial Control by the Companies?

   (a) Reliability of Financial Reporting

   (b) Effectiveness and efficiency of operations

   (c) Compliance with applicable laws and regulations

   (d) All of the above.

5. Which of the following statement is inappropriate with regard to testing methods as mentioned in Para 5 above?

   (a) Inquiry in combination with Inspection gives the most effective and efficient audit evidence.

   (b) Re-performance is the most effective as an audit test and gives the best audit evidence.

   (c) Inquiry should always be used in combination with any other testing method.

   (d) which audit test to use and in what combination does not require professional judgment.

Case Scenario 4

A Partnership Firm of Chartered Accountants by the name of S K and Associates were appointed as the Auditors of the Company named Big Box Ltd.

Para 1

Big Box Ltd is a Public Listed Company. The CA Firm comprised of 2 partners namely CA S and CA K. Subsequently, a close relative of CA K, acquired security having face value Rs.495000/- of Big Box Ltd. As per the provisions of Section 141 of the Companies Act 2013, an Auditor will be disqualified from appointment, if the Auditor himself or his relative acquires the security exceeding the prescribed limit in the Company.

Para 2

Further, the Auditors, S K and Associates also had to bank on the policies and procedures adopted by the Company for ensuring the efficient conduct of its business. They have to state about the adequacy of Internal Financial Controls in the Company. The Company had a turnover of Rs. 60 Crores as per the latest Audited Balance Sheet and its Borrowings during the year were Rs. 20 Crores from Banks.

Para 3

The CFO of the Company, Mrs. Darshana felt dubious in the Accounts department of the Company. She entreated the Auditors to perform a thorough investigation of the Accounts department. Mrs. Darshana was also anticipating a fraud in this situation. Both the Auditor as well as the CFO of the Company analyzed the various risk factors. The Auditors observed that the Head Accountant of the Department has inflated the Sales amount to finish his targets. There was collusion between the Head Accountant & Employees of the

Company. Employees were presented incentives on accomplishing their targets. This resulted in a fraud by the Head Accountant of amount aggregating to Rs.75 Lacs.

Para 4

Mr. X, an acquaintance of CA S, wanted to form an LLP with his distant relatives. He wanted to possess in-depth knowledge about LLP. CA S explained him that LLP is a separate legal structure and is liable to full extent of its assets but the partners are liable to the extent of their agreed contribution in LLP. Mr. X additionally wanted to know the criteria for the accounts of LLP to be audited. CA S enlightened him that the accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009.

Para 5

Big Box Ltd. is expanding its business. Consequently it requires many Computers. Purchasing computers may involve paying a huge upfront cost. Cash flow may get disrupted. Hence the Company came up with an idea of getting the Computers on lease. It will allow the businesses to have access to the latest technology without harming their cash flow.

The Auditors explained to the Directors that leasing Computers shall come under the purview of Operating Lease.

1. With reference to para 1, S K and Associates can take corrective actions within _______days. The relative may hold security or interest in the company of face value not exceeding ____________

(a) 45 days, Face Value Rs.100000/-
(b) 60 days, Market Value Rs.500000/-
(c) 30 days, Face Value Rs. 500000/-
(d) 60 days, Face Value Rs.100000/-

2. The Auditors of S K and Associates were doubtful concerning the applicability of Internal Financial Controls in the Company Big Box Ltd. With reference to details provided in Para 2 above, please guide them in this regard.

(a) It will be applicable as Turnover exceeds the threshold limit of Rs.50 Crores.

(b) It is not applicable as the Borrowings are less than 25 Crores during the financial year.

(c) It will be applicable as the Company is a Public Listed Company.

(d) Reporting on Internal Financial Control is not under the scope of Auditors reporting. Hence, Not Applicable.

3. With reference to para 3, wherein a fraud was observed by the Auditor, what should be the course of action of the Auditor?

(a) The Auditor should report the fraud details to Central Government.

(b) The Auditor shall report the fraud to the audit Committee or to the Board within the prescribed time.

(c) The Auditor shall disclose it in the Audit Report and report the fraud details to RBI too.

(d) Both a & c above.

4. With regard to information provided in Para 4, which of the following is a CORRECT option?

(a) Any LLP whose turnover does not exceed, in any financial year, Rs.40 Lacs or whose contribution does not exceed Rs.25 Lacs is not required to gets its accounts audited.

(b) Any LLP whose turnover does not exceed, in any financial year, Rs.50 Lacs or whose contribution does not exceed Rs.20 Lacs is not required to gets its accounts audited.

(c) Any LLP whose turnover exceeds Rs.25 Lacs in any financial year or whose contribution exceeds Rs.10 Lacs in any financial year is required to gets its accounts audited.

(d) Any LLP whose turnover does not exceed, in any financial year, Rs.40 Lacs and whose contribution does not exceed Rs.25 Lacs is not required to gets its accounts audited.

5. In reference to para 5, which among the following is an INCORRECT trait about the Operating Lease?

(a) The Lessee does not have the option to buy the asset during the lease period.

(b) The Lessee cannot claim Depreciation on the leased asset.

(c) The Lessee generally bears the Insurance, Maintenance and Taxes.

(d) The Lease term generally extends to less than 75% of the projected useful life of the leased asset.

Case Scenario - 5

Ms. Rhea was among the promoters who set up a public company by the name “Aksham Ltd”.

The company appointed CA Rajendra as the auditor of Aksham Ltd. CA Rajendra is the brother of one of the directors of Aksham Ltd. After setting up of company, the company had a dispute with one customer of the company in year 2019-20 who took the company to court. There are probable chances that company will have to shelve out ‘50 lakhs as compensation but the case will likely to be finalised in year 2021-22.

CA Rajender considers the fact that Askham Ltd has a present obligation and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and that a reliable estimate i.e. ₹ 50 Lakhs can be made of the amount of the obligation.

Aksham Ltd. declared dividend of ₹ 10 per equity share on 10th April,2021. The financial statements were approved on 30th June,2021. Askham Ltd took loan of ₹ 65 lakhs from Saksham Bank for a period of 10 years; the loan amount was guaranteed by Mr. Pramod, one of the directors of Aksham Ltd. The loan was completely secured against the fixed assets of the company. Aksham Ltd drew designs of one of the products of the company and this product constituted 90 % sales of the company. The designs of the product were such that the sale of the company will increase every year for the next 5 years. Aksham Ltd booked the designs of the company at a value of ₹ 1 crore in the books of account of the company as intangibles at its cost.

Based on the above information, answer the following questions:

1. State whether appointment of CA Rajendra is correct in law.

(a) Yes, it is correct in law as per Companies Act, 2013

(b) It is incorrect in law as per Companies Act, 2013 as the relative of director is not allowed to be appointed as an auditor of the company.

(c) It is correct in law as per Companies Act, 2013 because brother is not covered under the definition of relative.

(d) It is correct as appointment of auditor is not governed by any law in India.

2. Advise the company regarding the course of action Aksham Ltd will have to follow for the court case for financial statements prepared for year ending 31st March, 2021

(a) create provision

(b) create revenue reserve

(c) create capital reserve

(d) to be disclosed as contingent liability

3. What is the action which Aksham Ltd is supposed to take with regard to treatment of dividend declared while preparing and finalizing financial statements for year ending 31st March,2021?

   (a) recognise dividends as a liability **(b) disclose the amount of dividend**

   (c) both a and b (d) none of the above.

4. State the disclosures Aksham Ltd is required to make with respect to the long-term borrowings taken from Saksham Bank.

   I. Secured loan from Saksham Bank.

   II. The fixed assets are secured against the loan

   III. The loan of ‘ 65 lakhs is guaranteed by director.

   IV. Repayment terms of the loan

   (a) I, II, III and IV (b) I, II

   (c) I, II, III (d) II, III

5. State which of the following statement is true with respect to recording an intangible in the books of the company.

   (a) Intangible is correctly booked by the company.

   (b) Intangible is wrongly booked by the company as an intangible cannot be booked as per the accounting standard of India.

   (c) Intangible is wrongly booked by the company as an intangible cannot be booked as per the auditing standards of India.

   (d) Intangible is wrongly booked by the company as an intangible cannot be booked as per the Companies Act, 2013.

Case Scenario - 6

Best Tea House is a Co-operative society formed as per the provisions of the Co-operative Societies Act, 1912. It runs a chain of restaurants serving mainly tea and snacks in Delhi. RAS & Associates, a Chartered Accountant firm, has been appointed to conduct the statutory audit of the society. None of the partners of the firm, CA R, CA A and CA S have ever conducted a Co-operative Society audit before and so familiarise themselves with the provisions of the particular Act governing the society before starting the audit.

During the audit, Best Tea House informs the auditors that they have been in operation for the last five years, and no audit was required earlier since their turnover had not exceeded the prescribed limit.

While examining the books of account of Best Tea House, RAS & Associates notice that as stated under section 43(h) of the Central Act, certain rules were framed prescribing the books and accounts to be kept by Best Tea House.

The auditors also understand that 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 a certain percentage of the total number of shares or of the value of shareholding to a specified amount. RAS & Associates were concerned with this provision so as to watch any breach relating to holding of shares.

While examining the loans of Best Tea House, the auditors notice that the society has given a loan to a relative named Mr. P, of a member of the society, Mr. T, of an amount not exceeding ‘ 1000.

RAS & Associates examined the overdue debts and checked its classification which they are required to report.

During the audit, RAS & Associates notice few transactions for personal profiteering by members of the management committee, which are ultimately detrimental to the interest of the society. RAS & Associates report this matter to the required authority to take necessary action.

After the conclusion of the audit, in addition to the audit certificate in the prescribed form and various schedules, RAS & Associates also answered two sets of questionnaires called audit memos. The auditors also submitted the audit report in a narrative form addressed to the Chairman of the society which was divided into two parts styled as part I and part II.

Based on the above information, answer the following questions:

1. According to section 5 of the Central Act, what is maximum percentage of the total number of shares and what is the maximum value of shareholding that RAS & Associates were concerned with, so as to watch any breach relating to holding of shares?

(a) Twenty-five percent of the total number of shares or of the value of shareholding upto ₹ 5,000

(b) Twenty percent of the total number of shares or of the value of shareholding upto ₹ 5,000

(c) Twenty-five percent of the total number of shares or of the value of shareholding upto ₹ 1,000

(d) Twenty percent of the total number of shares or of the value of shareholding upto ₹ 1,000

2. As per Section 29 of the Central Act, Best Tea House cannot give a loan to any person other than:

(a) A member and with the special sanction of the Registrar, relatives of the member not exceeding an amount of ₹ 1000.

(b) A member and with the special sanction of the Registrar, another registered society.

(c) A member and with the special sanction of the Registrar, relatives of the member.

(d) A member and with the special sanction of the Registrar, another registered society not exceeding an amount of ₹ 1000.

3. Overdue debts for a period from _____________to_______ and more than _____ were classified and reported by RAS & Associates.

(a) 3 months to 6 months and more than 6 months.

(b) 6 months to 3 years and more than 3 years.

(c) 6 months to 5 years and more than 5 years.

(d) 3 months to 5 years and more than 5 years.

4. To whom does RAS & Associates report the few transactions noticed during audit?

(a) Registrar of Co-operative Societies

(b) Secretary of Best Tea House.

(c) State Government

(d) Management Committee of Best Tea House

5. Mistakes having an impact on the profitability of society were pointed out by RAS & Associates as it had a consequential effect on the financial position of society. In which of the following submissions was this information included?

(a) Part I of the audit report

(b) Part II of the audit report

(c) Schedules to the audit report

(d) Audit memos

General MCQs

1. To jointly audit books of accounts of WZ Limited for the financial year 2020-21 two different firms of Chartered Accountants namely MH and Associates and NR and Associates were appointed. MH and Associates and NR and Associates can together be called as:

   (a) Principal Auditors of WZ Limited. (b) Branch Auditors of WZ Limited.

   (c) Individual Auditors of WZ Limited. **(d) Joint Auditors of WZ Limited.**

2. Mr. H and his team members carefully watched the whole process of counting of finished wooden doors by employees of Bottom Limited. This is an example of which audit procedure:

   (a) External Confirmation. **(b) Observation.**

   (c) Inquiry. (d) Inspection.

3. Under section 43(h) of the Central Act, who can frame rules prescribing the books and accounts to be kept by a co-operative society?

   (a) Central Government **(b) State Government**

   (c) Management Committee of the Society. (d) Secretary of the Co-operative Society.

4. ………….. is the threat which occurs when auditors are deterred from acting objectively with an adequate degree of professional skepticism.

   (a) Familiarity threat (b) Advocacy threat

   (c) Self Review threat **(d) Intimidation threat**

5. The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are :

   (a) management **(b) those charged with governance**

   (c) audit committee (d) board of directors

Case Scenario - 7

Suresh Rana & Associates have been appointed as the statutory auditors of HAIL Ltd. by the Comptroller & Auditor General for the FY 2019-20. HAIL Ltd. is a Government company engaged in the manufacture of metro train coaches. During the course of audit, CA Suresh extended his scope of audit to cover efficiency, effectiveness and economy audit. CA Suresh Rana also asked his audit team to conduct expenditure audit as part of the audit engagement of HAIL Ltd.

During the course of audit, CA Suresh also found that the company has constructed its new stockyard for parking its metro coaches and maintenance of its metro coaches. However, the stockyard was not being used by the company for the designated purpose and the company continued using the rented stockyard. Suresh considered such expenditure as infructuous and avoidable expenditure.

The engagement partner also discussed with his team regarding the areas to be covered while conducting the audit of receipts. The reporting responsibilities of the engagement team were also discussed by the engagement partner with his team.

Based on the above facts, answer the following:-

1. **Statement 1**: Government audit provides public accounting of operational, management programme and policy aspects of public administration as well as accountability of officials administering them.

   Statement 2: Government audit is equipped and intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end.

(a) Only statement 1 is correct (b) Only statement 2 is correct

(c) Both 1 & 2 are correct (d) Both 1 & 2 are incorrect

2. …………. is conducted to ensure that the various programmes, schemes, and projects where large financial expenditure have been incurred are run economically and are yielding results expected of them:-

(a) Propriety audit (b) Audit against Rules and orders

(c) Performance Audit (d) Audit against Provision of funds

3. While conducting audit against provision of funds, the statutory auditors, M/s Suresh Rana & Associates must check:-

(a) That each item of expenditure is covered by a sanction either general or special of a competent authority.

(b) That the expenditure incurred has been on the purpose for which the grant and appropriation has been provided and the amount of expenditure does not exceed the appropriation made.

(c) That the expenditure conforms to the relevant provision of the constitution.

(d) That the expenditure is in accordance with the financial rules, regulations and orders issued by the competent authority.

4. Which part of expenditure audit covers the scrutiny of the expenditure incurred on the construction of stockyard by the company which is considered as infructuous and avoidable by CA Suresh Rana?

(a) Propriety Audit (b) Audit against provision of funds

(c) Audit of sanctions (d) Performance Audit

5. While conducting the audit of receipts of HAIL Ltd., which of the following area is to be covered as part of Audit of Receipts?

1. Whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities of HAIL Ltd.
2. Whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds.
3. Whether the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.
4. Whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them.

(a) Only statement 1 is correct **(b) Statements 1 & 2 are correct**

(c) Statements 1,2,3,4 are correct (d) Statements 1,2,3 are correct

Case Scenario - 8

RS & Associates have been appointed as the statutory auditors of MNO Ltd. for the Financial Year 2019-20. CA Ramesh is the engagement partner for the assignment. The management of MNO Ltd. has duly given a written representation letter to CA Ramesh regarding acknowledgement of its responsibility for the implementation and operation of accounting system and the internal control system of the company. The management has assured the audit firm that such accounting and internal control systems are designed and implemented to prevent and detect any misstatement on account of fraud or error.

During the course of audit, the auditor found that the wages cost has increased substantially as compared to the last year. On detailed checking CA Ramesh found that many new workers have been added to the workers list which appear to be dummy workers to CA Ramesh.

Further the auditor found that there was a fraud amounting to Rs. 2 crores committed during the year under audit by an officer of the company. Such fraud has already been reported by the Cost Accountant of the company, Mr. Sudesh, to the Central Government. The statutory auditors are considering their reporting responsibilities in this regard.

The audit team also realized that there is inadequate Internal Control System with respect to the following:

- The system of authorization and approval of transactions specially in the process of making purchases.
- The system of record keeping with respect to the assets.

Based on the above facts, answer the following:-

1. As the management of MNO Ltd. has given a written representation regarding its responsibility for prevention and detection of misstatement on account of fraud and error, M/s RS & Associates:-

(a) Should rely on such management representation and conduct its audit procedures without wasting much time and resources towards detection of fraud and error.

(b) Should not consider such management representation as a substitute for obtaining sufficient and appropriate audit evidence and design its audit procedures accordingly.

(c) Should not rely on such management representation and should obtain written representation from those charged with governance.

(d) Should concentrate on audit of accounting system and accounting policies so used by the company as the prevention and detection of fraud and error is the responsibility of the management.

2. The inclusion of dummy workmen in the workmen list by the management of MNO Ltd. as noticed by CA Ramesh amounts to:-

(a) Suppressing cash receipts (b) Casting wrong total in cash book

(c) Inflating cash payment (d) Misappropriation of goods

3. With respect to the fraud which has already been reported by The Cost accountant of the company, Mr. Sudesh, what is the responsibility of M/s RS & Associates in this regard?

(a) Since the reporting has been done to the Central Government by the cost accountant of the company, the statutory auditor has no responsibility for such fraud and its reporting.

(b) The cost accountant has detected and reported the fraud to the Central Government. The statutory auditor should not interfere in the work of the Cost Accountant.

(c) CA Ramesh should review the steps taken by the management with respect to the reported fraud and if he is not satisfied with such steps, he should request the management to perform additional procedures to enable him to satisfy himself that the matter has been appropriately addressed.

(d) CA Ramesh should obtain written representation from the management that once the matter is appropriately addressed, he will be duly informed by the management.

4. ……………..refers to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud:-

(a) Fraud Risk Factors (b) Misappropriation of assets

(c) Incentives/ Pressures (d) Fraud

5. **Statement 1**: The risk of auditor not detecting a material misstatement resulting from employee fraud is greater than for management fraud.

Statement 2: The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.

(a) Only statement 1 is correct **(b) Only statement 2 is correct**

(c) Both 1 & 2 are correct (d) Both 1 & 2 are incorrect

6. ………..is a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence/ non occurrence of one or more uncertain future events not wholly within the control of the entity:-

(a) Provisions (b) Reserves

(c) Contingent Liabilities (d) Liability

7. In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as :

(a) Monitoring **(b) Inspection**

(c) Subsequent Audit procedures (d) Compliance procedures

8. The concept of materiality is applied by the auditor :

(a) in planning and performing the audit

(b) in evaluating the effect of identified misstatements on the audit

(c) both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit

(d) none of the above is correct

9. ____________ in which the auditor selects the sample without following a structured technique.

(a) Haphazard selection (b) Monetary Unit Sampling

(c) Block Sampling (d) Structured Sampling

10. The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are :

(a) management **(b) those charged with governance**

(c) audit committee (d) board of directors

Case Scenario - 1

SaveLives Limited is a listed Company which deals in the manufacture of Sanitizers, floor cleaners, dish and fabric cleaners etc. In spite of spread of covid 19 in the country, the company's sales have been very high in the last financial year due to essential products it deals in. The Company is highly automated and is driven by IT systems and applications that are used in the preparation of the financial statements of the Company. The Company uses an integrated enterprise resource planning system since last five years.

KRAN & Associates has been appointed to conduct the statutory audit of the Company. The firm consists of eight partners, and CA N has been appointed as engagement partner for the audit of SaveLives Limited.

CA N briefed the team about the audit and also how IT would be relevant to the audit of SaveLives Limited. The team obtained an understanding of the entity and its aut omated environment which involved an understanding of how the IT department was organised, IT activities, IT dependence and the relevant risks and controls.

One of the team members wanted to understand the importance of different types of controls in an automated environment viz., General IT Controls, Application Controls and IT- Dependent Controls. Same was discussed in detail along with the relationship between different controls.

The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. So, CA N decided to himself evaluate and validate the design and operating effectiveness of Internal Financial Controls over Financial Reporting (IFC-FR) of the company as at the Balance Sheet date. Internal Financial Controls (IFC) refers to the policies and procedures put in place by SaveLives Limited for ensuring adequacy and also the operating effectiveness of such controls.

The audit team decided to use the tools and techniques that auditors use in applying the principles of data analytics which are known as CAATs. Data analytics could also be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform various functions.

1. Under which situation is IT not relevant to an audit?

(a) Increased complexity of transactions

(b) Hi-tech nature of business

(c) Volume of transactions is low

(d) Company Policy (Compliance).

2. Which of the following is a risk that arises from the use of IT systems?

(a) Direct data changes (backend changes).

(b) Limited/Monitored access.

(c) Adequate segregation of duties.

(d) Authorized access to data.

3. The relationship between two controls is such that _____________ are needed to support the functioning of _______________, and both are needed to ensure complete and accurate information processing through IT systems.

(a) IT Dependent Controls, General Controls

(b) Application Controls, General Controls.

(c) General Controls, IT Dependent Controls.

(d) General IT Controls, Application Controls.

4. The term Internal Financial Controls (IFC) refers to the policies and procedures put in placeby companies for ensuring which of the following:

(a) reliability of financial transactions.

(b) effectiveness and efficiency of operations.

(c) safeguarding of human resources.

(d) prevention and detection of errors.

5. Data analytics can be used in testing of electronic records and data residing in IT systemsusing spreadsheets and specialized audit tools viz., IDEA and ACL to perform which of thefollowing:

(a) Evaluating impact of control deficiencies.

(b) Compliance with applicable laws and regulations.

(c) Authorized changes to system or programs.

(d) Providing latest information.

Case Scenario - 2

You are a partner in ABC & Company, a Chartered Accountant firm based in New Delhi. ABC & Company has been appointed as the statutory auditor of onetime Limited, a public limited company which manufactures and sells wall and table clocks and has many branches all over India. onetime Limited has been exporting the clocks since past two years. However, the domestic sales have contributed towards major source of revenue for the Company.

You being the engagement partner have started the audit for the year ended 31.03.2021 along with your five team members. One of the team members, CA B started verification of inventory.

In addition to other procedures, he also checked that valuation of Inventory had been recognised in accordance with AS -2. During detailed checking, he noticed that the amount spent on salary of administrative employees and normal wastage on production of the clocks, had not been added to the valuation of Inventory. The contention of XYZ Limited was that since the co st was not directly related to the production cost and so not added to the cost of inventory.

CA B also noticed that one of the suppliers of onetime Limited, Mr AM had sent some raw material to the Company for storage in their warehouse in March 2021. Due to renovation going on at his warehouse, his stock could be damaged and so he had requested Onetime Limited to keep the same in their warehouse. onetime Limited contended that since the raw material was anyway billed to the Company the next month, so the same had been included in the valuation of stock, since physically the stock was present in the warehouse of Onetime Limited as on 31.03.2021.

The Company had issued shares at premium, and the premium received on the shares had been transferred to a "securities premium account". The same was then applied in writing off the expenses of selling the clocks, writing off the preliminary expenses of the Company and also writing off the commission paid to the sales agents. You have verified the same in detail.

While verifying debtors, team member C noticed that there were a few trade receivables pertaining to export sales mainly to England. Mr. C verified the same with respect to the invoices issued and other supporting documents. The amount booked as on 31.03.2021 was based on the exchange rate as on the date of the invoice.

Mr. T, another team member verified the fixed assets of the Company. onetime Limited had purchased few cars for its directors during the year of audit. The same were appearing in the fixed assets schedule of the Company. Mr T verified the same with respect to the invoices as well as physically verified the assets in the Company's premises. Since the cars were for the official use of the Directors, they were purchased in the name of the Directors of the Company.

Mr. T verified the amount with the Invoice and checked the registration and insurance documents.

One of the article clerks was assigned the work of verification of "Provisions" appearing in the Balance sheet. He wanted to understand from you the circumstances in which a provision is recognised in the books of account. You explained him the situations in which an entity recognises Provisions in its books.

Onetime Limited has invested in the shares of other companies. One of the Compan ies has declared dividend on its shares. Onetime Limited has not recognised the same in the profit & loss account. Team Member R has asked you to look into the matter since she is unable to understand the reasons for the same.

The Company had spent a huge amount on repair and maintenance of the machinery used for the production of the clocks. The amount was accounted for in two parts: repairs were booked as a revenue expenditure and annual maintenance charges were capitalised and added to the machinery cost. Ms. R has verified the same in detail and raised her observations.

1. Is the raw material lying in the warehouse of onetime Limited accounted for correctly in its books of account?

   (a) No, since the same belongs to Mr. AM and should appear in his books.

   (b) Yes, since the same is in possession of onetime Limited and was billed to it the following month.

   (c) It should be shown in the books of both onetime Limited and Mr. AM.

   (d) It should not appear in the books of onetime Limited or Mr. AM and the raw material should be disclosed as a note in the final accounts of both the entities.

2. Which exchange rate is considered for accounting of foreign debtors at the year end?

   (a) Exchange Rate on the date of the invoice.

   (b) Exchange Rate on the last day of the financial year.

(c) Exchange Rate on the date of shipment of the products to the customer.

(d) Exchange Rate on the date of delivery of the products to the customer.

3. Which of the following assertions with respect to fixed assets has not been compl ied with by the Company?

(a) Existence
(b) Valuation
(c) Cut-Off
(d) Rights and Obligations

4. Which of the following condition is not required to be met for recognizing a provision?

(a) When a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

(b) When an entity has a present obligation (legal or constructive) as a result of a past event.

(c) A reliable estimate can be made of the amount of the obligation.

(d) When it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

5. Dividends are recognized in the statement of profit and loss only on fulfilment of which condition:

(a) the entity's right to receive payment of the dividend is established.

(b) it is probable that the economic benefits associated with the dividend will flow to the entity.

(c) the amount of the dividend can be measured reliably.

(d) All of the above

6. A type of super user access to information systems that enforces less or no limits on using that system is known as:

(a) Super access.
(b) Super user access.
(c) Unlimited access.
(d) Privileged access.

7. Which of the following is not an example of inflation of payments:

(a) Making payments against fictitious vouchers.

(b) Adjusting unauthorized or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.

(c) Making payments against vouchers, the amounts whereof have been inflated.

(d) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.

8. _____requires firms to establish policies and procedures for the retention of________. The retention period for audit engagements ordinarily is no shorter than ______from the date of the auditor's report, or, if later, the date of the group auditor's report

(a) SA 220, audit evidence, six years

(b) SA 200, audit documentation, seven years

(c) SQC 1, engagement documentation, seven years

(d) SA 230, documentation, six years

9. …………. is the threat which occurs when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised

(a) Familiarity threat **(b) Advocacy threat**

(c) Self Review threat (d) Intimidation threat

10. _______refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

(a) Internal control assessment procedures **(b) Risk assessment procedures**

(c) substantive procedures (d) analytical procedures

PART II B – DESCRIPTIVE QUESTIONS

1. State with reason (in short) whether the following statements are true or false:

(i) No entry is passed for cheques received by the auditee on the last day of the year and not yet deposited with the Bank.

(ii) Written representation from management can be a substitute for other evidence that the auditor could expect to be reasonably available.

(iii) According to Para 3(1)(d) of CARO, 2020, an auditor needs to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 5% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets

(iv) Communicating key audit matters in the auditor's report is a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern

(v) A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

(vi) It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the RBI and agreed upon by the concerned statutory auditors. Special consideration need not be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

(vii) The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971

(viii) Before holding inquiry by the Central Registrar thirty days' notice must be given to the Multi-State co-operative society.

Ans. (i) Incorrect: The person who is controlling the trade receivables should ensure that proper accounting entries have been passed by crediting respective trade receivables account. The balance of cheque in hand should be disclosed along with the cash and bank balances in the financial statements.

(ii) Incorrect: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

(iii) Incorrect: According to Para 3(1)(d) of CARO, 2020, an auditor needs to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets

(iv) Incorrect: Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern

(v) Incorrect: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons.

A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

(vi) Incorrect: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

(vii) Incorrect The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013

(viii) Incorrect: Before holding inquiry by the Central Registrar fifteen days' notice must

be given to the Multi-State co-operative society.

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