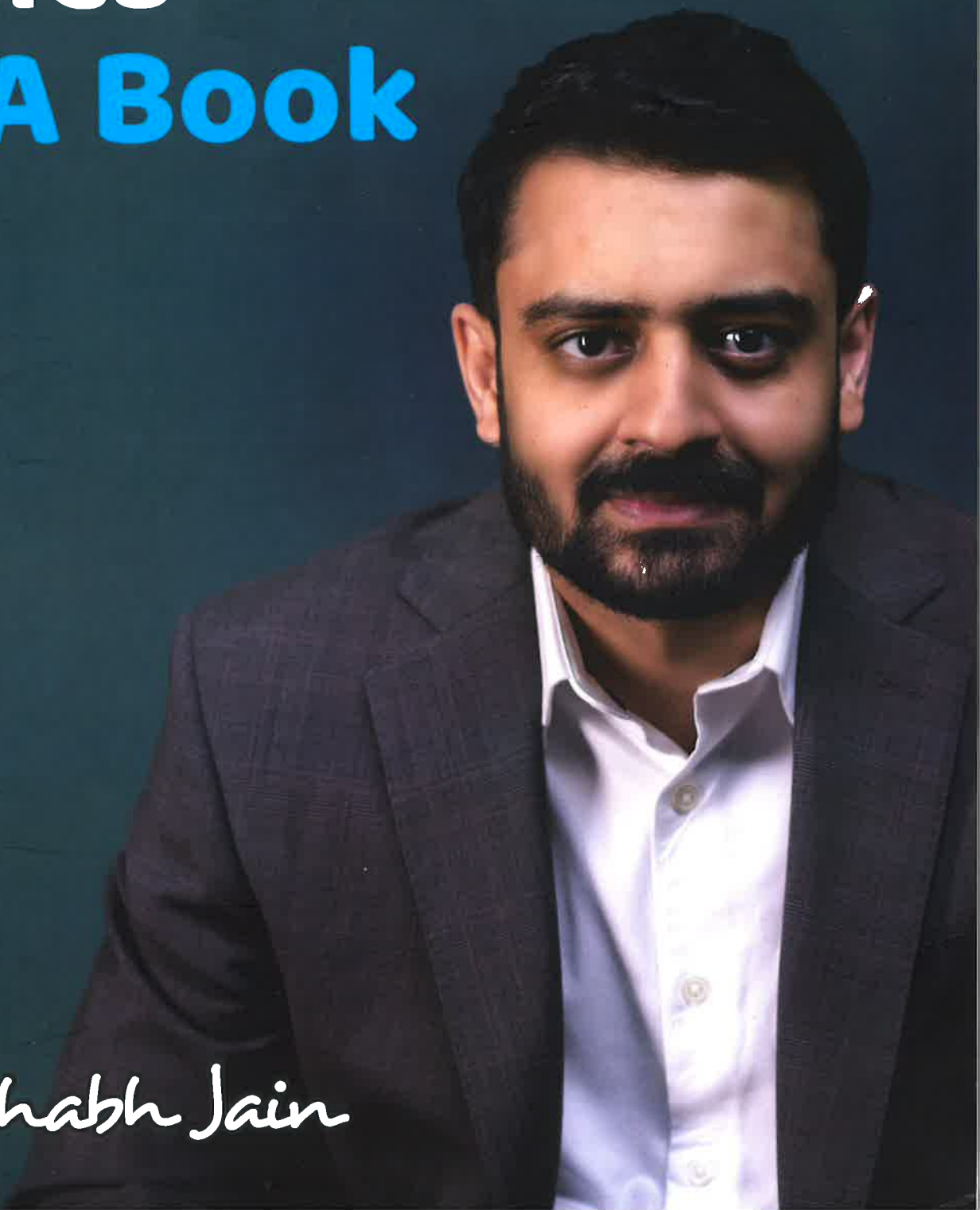
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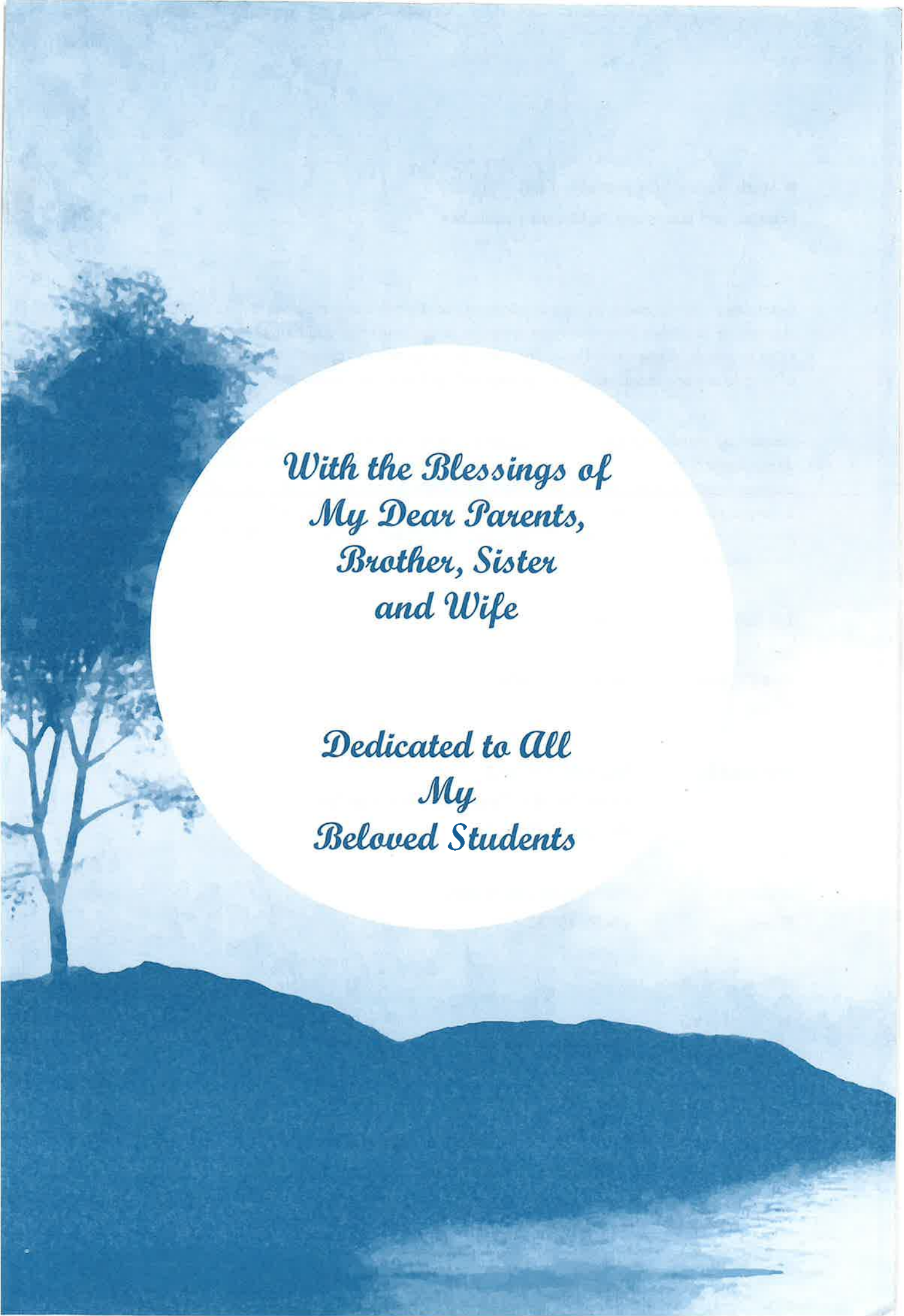
NEW SYLLABUS

AUDITING & ETHICS

Q&A Book



CA Rishabh Jain



With the Blessings of
My Dear Parents,
Brother, Sister
and Wife

Dedicated to All
My
Beloved Students

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PREFACE

Dear students,

It gives me immense joy and pleasure to present a completely updated **CA Inter – Auditing and Ethics Q and A Book strictly** as per **ICAI New Syllabus.**

In this Updated QnA Module we have covered the following:-

1) All ICAI Module questions as per New ICAI Syllabus
2) Old Syllabus Exam paper questions with ICAI suggested answers
3) Old syllabus RTP and MTP questions with suggested answers which are still relevant for new syllabus chapters.

This book was prepared with the aim of making sure that anyone who reads this gets not only a **substantial coverage over the ICAI syllabus** but also, **resounding confidence over their practical applicability when you are working in the corporate world.**

Having been a professor for 10 years and counting, I have observed that, for you to succeed in exam and your professional career you need a great understanding of the concept and its real-life application. Majority students get stuck in the rat race of just passing the exam by any means, this may help you to pass a competitive exam but not in the exam of your professional life.

I have worked for more than **6 years** in **Big 4's like PWC and Deloitte** in my initial years of professional career and the lessons learned during that time has inspired me to ensure that my students get a **"Practical Approach"** to this so called **"Theoretical world of Auditing".**

The journey of a Chartered Accountant is not a rapid T-20 match. **It is equivalent to a 5-day test match, if you will.** Rather than rushing and blasting through your preparation, it is crucial to be consistent and disciplined. **My cricket coach once said to me something that has stuck with me since my college days – 'Wicket pe bane raho, runs aapne aap ban jaayenge!'**

I wish you all the best and hope that you be greatly benefited from this book!

Happy Learning,

Regards

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'Failure will never overtake me if my determination to succeed is strong enough!'

- Late Dr. A P J Abdul Kalam

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There are people in this world, some of them so wonderful, that made this book become a reality that you are holding in your hand. I would like to thank all of them.

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Mr. Sharad Patil who has taken immense effort in creating this Book.

&

Mr. Vikas Ingawale who has taken immense efforts in Designing this book in the most creative way.

"Alone we can do so little,
together we can do so much"

CA INTER

Auditing and Ethics

Q&A Module

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RJ = Practical Insight into Theoretical World

CHAPTER 1

NATURE, OBJECTIVE AND SCOPE OF AUDIT

Case Study 1

Rohit, Gurpreet, Ali and Goreti are friends since their school days based in Mumbai. They have cleared CA foundation exams in the same attempt and now plan to appear for CA Intermediate exams. All of them are avid news listeners and regularly keep track of business news even on social media.

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started attending Live Coaching Classes (LCC) being conducted by Board of studies of ICAI. Goreti has not been able to join Live Coaching Classes yet as she was away on a holiday with her parents. However, she plans to catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They discussed many things regarding its nature, scope, benefits and other general practical issues. Goreti was regular in keeping track of audited results of companies being published in leading newspapers. Her view was that audited financial statements of companies give 100% guarantee to different stake holders. It is the main reason behind so much reliance upon auditing. But she could not understand why wrong doings in financial matters are being discovered after many years have gone by.

Ali also concurred with her view and added that when financial statements are audited, each and every transaction appearing in books of accounts is verified. However, he could not give clarity to Goreti.

Gurpreet was of the opinion that audit was conducted on the basis of sample checking. He was also of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of the companies.

Not to be left behind, Rohit also jumped in the fray. He supported Gurpreet and also added something of his own.

Based upon above, answer the following questions:

1) Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?
   a) It provides reasonable assurance meaning a moderate level of assurance.
   b) It provides reasonable assurance meaning a low level of assurance.
   c) It provides reasonable assurance meaning a high level of assurance.
   d) It provides reasonable assurance meaning an absolute level of assurance.

2) Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do so?
   a) Yes, he can do so. It is necessary to obtain audit evidence.
   b) Yes, he can do so. There are express rights given to him in this respect.
   c) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him.
   d) No, he cannot do so. He has no right of seeking information and documents. Therefore, question of forcing does not arise.

3) Ali had listened in one of the classes that audit covers all aspects of an entity and concluded that each and every transaction of entity is verified by auditor. Goreti also seemed to be in agreement with him but she was of the view that besides this, it also meant that audit should be so organized to cover all areas of an entity. Which of following statements is appropriate in this regard?
   a) Only view of Ali is correct.
   b) Only view of Goreti is correct.
   c) Views of both Ali and Goreti are correct.
   d) Views of both Ali and Goreti are incorrect.

4) All of them also discussed about benefits of auditing. Which of the following is not a likely benefit of auditing?
   a) Since auditing is connected to future events, audited information can be easily relied upon by users.
   b) Errors or frauds may be discovered during audit.
   c) Government authorities can make use of audited accounts for different purposes.
   d) It can help in bringing out deficiencies in maintenance of financial records.

5) Goreti told her friends that she had read a news report about how a company had misled its auditors by producing some fabricated documents. Which of following statements seems to be appropriate in this regard?
   a) It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.
   b) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.
   c) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.
   d) Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare odd cases.

Answers to Case Study 1:

1) c)
2) c)
3) d)
4) a)
5) c)

Case Study 2

Me and You Private Limited has been newly incorporated. The plant of the company has recently started production with the help of funds provided by a bank for purchase and installation of machinery. Further, the company is also utilizing working capital credit facilities from the same bank for meeting its day to day working capital requirements like for purchase of raw materials, labour payment etc. However, just within six months of its operations, the management feels that working capital funds are inadequate and situation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working capital credit facilities. The bank manager is insisting upon financial statements of the company for half year along with report providing assurance in this respect duly signed by Chartered Accountant as audit is far away. It also requires projected financial statements for coming years along with a report from CA providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing assurance for half yearly results and projected financial statements are sought from CA P. The Management provides necessary information and records to him in this regard.

Assume, in above case, the company only provides trial balance, financial statements in draft/preliminary form along with accompanying records for the relevant half year to CA P and requests him to provide duly signed financial statements with a report for mutually agreed professional fees.

Based on above, answer the following questions:

1) The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?
   a) Standards on Review Engagements
   b) Standards on Auditing

c) Standards on Related Services

d) There are no standards for issuing report in such situation.

2) Which of the following statements is MOST APRROPRIATE in given case situation?

a) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work.

b) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.

c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.

d) The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report

3) In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the MOST APPROPRIATE statement:

a) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.

b) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.

c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.

d) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.

4) The banker of company has also requested for projected financial statements for coming years along with a report from CA regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?

a) Standards on Review Engagements

b) There are no standards for issuing such type of reports.

c) Standards on Related Services

d) Standards on Assurance Engagements

5) Suppose CA P also accepts work of issuing projected financial statements with a report to be signed by him. The management has projected turnover of ₹ 100 core for the next year, ₹ 150 crore & ₹ 200 crore for following years respectively as compared to present turnover of ₹ 25 crore in current half year. Identify the MOST APPROPRIATE statement in this situation:

a) CA P has to satisfy himself regarding arithmetical accuracy of projected data.

b) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.

c) CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.

d) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.

Answers to Case Study 2:

1) c)
2) c)
3) c)
4) d)
5) d)

Independent MCQ's

1) Which of the following is not an advantage of audit?

a) It provides high quality financial information.

b) It acts as a moral check on employees.

c) It enhances risk of management bias.

d) It helps in safeguarding interests of shareholders.

2) Which of the following is NOT TRUE about an assurance engagement?

a) It relates to providing assurance about historical financial information only.

b) The practitioner obtains sufficient appropriate evidence.

c) There is some information to be examined by practitioner.

d) A written assurance report in appropriate form is issued by practitioner.

3) Which of the following is TRUE about Engagement Standards?

a) Engagement standards ensure proper rights to practitioners in course of performance of their duties.

b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner.

c) Engagement standards ensure uniformity by practitioners in course of performance of their duties.

d) Engagement standards ensure savings in resources of clients.

4) Consider following statements in relation to "Limited assurance engagement":-

Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.

Statement II - Review of interim financial information of a company is an example of limited assurance engagement.

a) Statement I is correct. Statement II is incorrect.

b) Both Statements I and II are correct.

c) Both Statements I and II are incorrect.

d) Statement I is incorrect. Statement II is correct.

5) Which of the following is TRUE about Standards on auditing?

a) These deal mainly with voluntary responsibilities of auditors

b) These deal mainly with mandatory responsibilities of auditors.

c) Their sole purpose is to help government authorities in augmenting revenues.

d) These deal mainly in carrying out audit according to legal provisions.

Answers to the MCQs based Questions:

1) c)
2) a)
3) c)
4) d)
5) b)

Correct/Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **The basic objective of audit does not change with reference to nature, size or form of an entity.**

Ans: Correct: An audit is an 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. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

2) **The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.**

Ans: Correct: As per **SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"**, the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

3) **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.**

Ans: Correct: As per **SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing"**, 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, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

Answer:

An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors.

An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error.

Hence, thinking of Lalji Bhai is not correct.

Question 2: **(ICAI SM)**

Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean. During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

Answer:

Proper disclosure of financial information is well within scope of audit.

Question 3: **(ICAI SM)**

A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?

Answer:

Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

Question 4: **(ICAI SM)**

Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm. However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel. The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation

Answer:

It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

Question 5: **(ICAI SM)**

The management of Exotic Tours and Travels Limited requests its auditor Raja & Co.to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures. Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

Answer:

Such report would be in nature of "review". However, auditors would have to obtain sufficient appropriate evidence.

Question 6: **(ICAI SM)**

CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing. Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

Answer:

He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such departure.

Question 7: **(ICAI SM)**

"Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management". Do you agree? Discuss duty of auditor, if any, in relation to accounting policies.

Answer:

Choosing of appropriate accounting policies is responsibility of management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management- Refer to scope of audit- what it includes.

Question 8: **(ICAI SM)**

An assurance engagement involves a three-party relationship. Discuss meaning of three parties in such an engagement.

Answer:

1) A three-party relationship involving a practitioner, a responsible party, and intended users an assurance engagement involves abovesaid three parties.
2) A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
3) A responsible party is the party responsible for preparation of subject matter.
4) Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

Question 9: **(ICAI SM)**

A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement.

Answer:

It is not a reasonable assurance engagement. It is in nature of investigation.

Question 10: **(ICAI SM)**

An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

Answer:

1) The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.
2) Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

3) The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.
4) An auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.
5) It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

Questions from Past Exams/RTP/MTP [As per OLD Syllabus]

Question 11: **(MTP Oct 21)**

Discuss the following:
The person conducting the audit should take care to ensure that financial statements would not mislead anybody. Explain

Answer:

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:

1) the accounts have been drawn up with reference to entries in the books of account;
2) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
3) 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;
4) the information conveyed by the statements is clear and unambiguous;
5) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
6) the statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

Notes:

CHAPTER 2

AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

Case Study

Kaur & Associates, a sole proprietor firm of Simran Kaur, is offered appointment as auditor of a company engaged in manufacturing of automobile components for the first time. She is fact checking about the integrity of promoters of the company and key managerial persons. Matters such as competence of staff to perform the engagement are also considered by her. The appointment is subsequently accepted by her.

She is also taking into account number and location of branches of the company, requirements of Schedule III of Companies Act, 2013 and expected time by which audit has to be completed keeping in view statutory requirements. Initially, she has thought it proper to inquire key employees of the company in procurement and marketing departments and planned for the same. She has also planned to visit three plants of the company. The purpose of planned inquiry and visit is to identify and assess risk of material misstatements.

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc. During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process. However, no instructions have been given to engagement team in this regard.

Based on above, answer following questions:

1) Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?
   - **a)** She is establishing audit strategy.
   - **b)** She is conducting preliminary engagement activities.
   - **c)** She is designing audit plan.
   - **d)** She is checking her compliance of ethical requirements.

2) Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -
   - **a)** Developing audit plan
   - **b)** Establishing overall audit strategy
   - **c)** Designing audit programme
   - **d)** Designing risk assessment procedures

3) Taking into account description of planned inquiry and visit, which of the following statements is TRUE?
   a) Planned inquiry and visit fall in area of audit strategy.
   b) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.
   c) The said description is not related to audit planning.
   d) Planned inquiry and visit fall in scope of audit programme.

4) What is detailed set of instructions given to assistants in engagement team known as?
   a) Audit guidelines
   b) Audit plan
   c) Audit Programme
   d) Audit Procedures

5) The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?
   a) She should ignore this information as audit has already begun.
   b) She should modify earlier set of instructions.
   c) She should leave the matter to wisdom of engagement team.
   d) She should put the ball in court of management as she was not provided with complete information earlier

Answers to Case Study

1) b)
2) b)
3) b)
4) c)
5) b)

Independent MCQ's

1) Which of the following is not considered in planning an audit generally?
   a) Understanding of legal and regulatory framework of an entity
   b) Need to consider determination of materiality
   c) Evaluating audit evidence
   d) Need to consider involvement of expert

2) Which of the following is true about audit plan?
   a) Once an audit plan has been finalized for an engagement, changes cannot be made to it.
   b) Audit plan includes scope, timing and direction of planned risk assessment procedures.
   c) Changes in audit plan cannot lead to change in audit strategy.
   d) Audit plan has to be documented by auditor.

3) Which of the following is not included in an audit programme normally?
   a) Extent of checking
   b) Date of checking
   c) Nature or type of procedure
   d) Planning of risk assessment procedures

4) Which of the following is not an advantage of an audit programme?
   a) It acts as a guide for audit of coming years.
   b) It fixes responsibility of assistants.
   c) It serves as a shelter for assistants.
   d) It serves a proof of work done by auditor.

5) Which of the following is most important principle for formulating an audit plan?
   a) Gaining knowledge of client's workforce
   b) Gaining knowledge of client's business
   c) Gaining knowledge of client's vendors
   d) Gaining knowledge of tax laws applicable to client

Answers to the MCQs based Questions:

1) c)
2) d)
3) d)
4) c)
5) b)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **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.**

Ans: Correct: Once the overall audit strategy has been established, an audit plan can be developed 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.

2) **Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.**

Ans: Incorrect: 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.

3) **Planning is a discrete phase of an audit.**

Ans: Incorrect: Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin 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.

4) 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.

5) The audit plan is more detailed than the overall audit strategy.

Ans: Correct: 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.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Does consideration for involvement of experts by auditors fall in the domain of planning audit?

Answer:

Consideration for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary. In the stated case, company is involved in technical and complex operations. Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary.

Question 2: **(ICAI SM)**

CA Kartik is planning for audit of a company engaged in manufacturing of cosmetics. Considering nature of operations of the company, he had planned to include testing of controls of the company over purchases, sales and inventories. One fine day, he reaches the corporate office and asks for manuals and required documentation to ensure surprise element in testing. He had never shared with management his intention to carry out above procedures. Is approach of CA Kartik proper?

Answer:

In the case, CA Kartik has reached office of the company without sharing with management his intention to test the controls.

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit.

Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, approach of CA Kartik is not proper.

Question 3: **(ICAI SM)**

CA Mary, while planning audit of a company, feels that she would inquire from inhouse legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. Considering above description, are you able to identify said procedures? Where these identified procedures are included in planning in accordance with SA-300?

Answer:

These are planned risk assessment procedures to identify and assess risk of material misstatement. The objective of planned inquiry of inhouse legal counsel is to identify and assess risk of material misstatement.

Such planned risk assessment procedures are included in audit plan in accordance with SA-300.

Question 4: **(ICAI SM)**

CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?

Answer:

Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company.

Noncompliance of the same can have implications in form of civil and criminal liabilities. Such an important matter concerning changes in laws and regulations is to be considered by auditor while establishing overall audit strategy.

Question 5: **(ICAI SM)**

Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc. During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum. Is attitude of Rohit proper?

Answer:

Attitude of Rohit is not proper.

The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

Question 6: **(ICAI SM)**

Discuss how performing preliminary engagement activities as part of planning an audit assists auditor.

Answer:

Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.

Question 7: **(ICAI SM)**

Discuss how an engagement partner ensures that firm complies with relevant ethical requirements including independence in relation to client.

Answer:

1) The auditor shall continuously evaluate compliance with ethical requirements including independence.
2) "Independence" means that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.
3) If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.
4) The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: -
   a) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence
   b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and
   c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation.
5) The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. Besides, consideration for client continuance and compliance with ethical requirements, preliminary engagements activities also include establishing an understanding of terms of engagement.

Question 8: **(ICAI SM)**

"Purported disadvantages of an audit programme can be overcome". Do you agree?

Answer:

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

Question 9: **(ICAI SM)**

An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure

Answer:

1) 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.
2) 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.
3) 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.
4) 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.
5) 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.

Question 10: **(ICAI SM) / (RTP Nov 21)**

SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members.

Answer:

1) The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.
2) 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: -

a) The size and complexity of the entity.
b) The area of the audit.
c) The assessed risks of material misstatement
d) The capabilities and competence of the individual team members performing the audit work.

Questions from PAST Exam / RTP / MTP (As per OLD Syllabus)

Question 11: **(Dec. 21)**

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.

Answer:

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

1) 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.
2) 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.
3) 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.
4) 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.

Question 12: **(MTP Mar. 22)**

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.

Answer:

Some disadvantages are there in the use of audit programme. The disadvantages are:

a) 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.

b) 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.

c) 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.

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

Question 13: **(MTP Apr 22)**

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.

Answer:

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:

a) Identify the characteristics of the engagement that define its scope;

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

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

d) 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

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

Question 14: **(RTP Nov 21)**

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. Explain clearly those ways

Answer:

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:

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

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

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

d) 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.

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

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

Question 15: **(RTP May 21)**

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.

Answer:

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

CHAPTER 3

RISK ASSESSMENT AND INTERNAL CONTROL

Case Study 1

CA Paritosh is auditor of a company. The financial statements of the company have just been received for audit. Following issues have been flagged pertaining to the financial statements of the company for purpose of risk assessment: -

(i) The revenue of company has fallen from ₹ 50 crore in last year to ₹ 5 crore in current year (for which financial statements have been received for audit) due to lack of demand in the market for company's products.

(ii) Due to advent of new products in the market, company's products are fast becoming outdated.

(iii) A large customer having an outstanding balance of ₹ 5 crore has failed to pay to the company despite efforts made by the company.

(iv) Inventory holding period has increased from 30 days in last year to 90 days.

(v) The company also gets carried out job operations from third parties. Therefore, parts of inventories are lying with third parties.

Based on above, answer the following questions:

1) Regarding drastic fall in revenue of the company, which of the following is an audit risk?

a) Fall in revenue would result in fall of profits for the company.

b) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.

c) The company can explore some new line of activity, if demand of its products is falling.

d) Fall in revenue would mean lower tax liabilities for the company.

2) The company's products are getting outdated in the market. Which of the following is an audit risk?

a) The company should devise strategies to sell products in the market.

b) Inventories may be understated in such a scenario.

c) Inventories may be overstated in such a scenario.

d) The company should launch a 1+1 free offer for its customers.

3) A large customer has failed to pay to the company. Identify audit risk from below:
   a) Receivables may be misstated if irrecoverable debt is not written off.
   b) Receivables may be overstated if irrecoverable debt is not written off.
   c) Writing off irrecoverable debt would impact profits of company adversely.
   d) Failure to recover outstanding debt would impact cash flows of company adversely.

4) Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.
   a) There is a risk of overstatement of inventories.
   b) There is a risk relating to existence of inventories.
   c) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased.
   d) There is a risk relating to holding and storage cost of inventories.

5) Part of inventories are lying with third parties. Identify audit risk involved.
   a) There is a risk that third parties do not manufacture according to specifications of the company.
   b) There is a risk that by getting job work done from third parties, company is increasing its costs.
   c) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.
   d) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties.

Answers to Case Study 1:

1) b)
2) c)
3) b)
4) a)
5) c)

Case Study 2

CA Piyush is understanding internal controls as part of audit exercise of a company. It is a new client. He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management. Till now, he has studied controls over inventories and bank. Few of such controls are listed below:

Nature of Control	Control description
Control over inventories	Inventories of the company lying at each location should be insured.
Control over inventories	There should be inventory counts on a regular basis for each location of the company.
Control over Bank operations	Bank reconciliations are to be performed at regular intervals.

Based on above, answer the following questions:

1) Which of the following most appropriately describes test of control regarding insurance of inventories?
   a) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.
   b) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.
   c) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.
   d) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.

2) Which of the following most appropriately describes test of control regarding inventory counts?
   a) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.

b) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.

c) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.

d) Attend inventory count and perform test count.

3) While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of "control deficiency" in this regard: -

a) Bank reconciliations are not being performed regularly as concerned staff is overburdened.

b) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.

c) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.

d) Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.

4) Since the company is a new client, which of the following statements is most appropriate?

a) There is reduced detection risk.

b) There is increased detection risk.

c) There is no effect on detection risk.

d) Detection risk should be increased to lower audit risk.

5) Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?

a) More substantive procedures would require to be performed.

b) Less substantive procedures would require to be performed.

c) There is no effect on substantive procedures.

d) There is no effect on substantive procedures as audit risk is low.

Answers to Case Study 2:

1) b)
2) c)
3) c)
4) b)
5) a)

Independent MCQ's

1) Which of the following is true regarding materiality?
   a) It is unaffected by nature of an item.
   b) It is unaffected by requirements of law or regulations.
   c) It is not a matter of professional judgment.
   d) It is not always a matter of relative size.

2) The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?
   a) It results in complex business environment.
   b) It results in simple business environment and easier audit.
   c) Automation has no relationship with complexity of business environment.
   d) It results in simple business environment. However, it increases complexity of audit.

3) Who is responsible for maintaining effective internal financial controls?
   a) Statutory auditor
   b) Audit Committee
   c) Management
   d) Shareholders

4) Which of the following is not a risk to a company's internal control due to its IT environment?
   a) Potential loss of data
   b) Inability to access data when required
   c) Unauthorized access to data
   d) Processing of large volumes of data

5) Which of the following is not an example of "General IT controls"?
   a) Controls pertaining to Disaster recovery plan
   b) Controls pertaining to batch preparation
   c) Controls pertaining to data security
   d) Controls pertaining to validation of input data in an application

Answers to the MCQs based Questions:

1) d)
2) a)
3) c)
4) d)
5) d)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **There is direct relationship between materiality and the degree of audit risk.**

Ans: **Incorrect:** There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

2) **Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.**

Ans: **Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

3) Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

Ans: Incorrect: Tests of Control are performed to obtain audit evidence about the effectiveness of:

a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and

b) the operation of the internal controls throughout the period.

4) Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

Ans: Incorrect: The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

Wear & Tear Private Limited is a "start-up" engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

Answer:

It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements.

The component of risks of material misstatement involved is "inherent risk."

Question 2: **(ICAI SM)**

A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

Answer:

The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations.

The component of risks of material misstatement is "control risk".

Question 3: **(ICAI SM)**

Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

Answer:

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. **The risk alluded to it is "detection risk".**

Question 4: **(ICAI SM)**

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.

Answer:

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue.

Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

Question 5: **(ICAI SM)**

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

Answer:

1) It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year).
2) The auditor is using "analytical procedures" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities.
3) It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

Question 6: **(ICAI SM)**

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act,2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

Answer:

If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

Question 7: **(ICAI SM)**

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

Answer:

The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company.

By gaining such a knowledge, she can better understand internal control of the company.

Question 8: **(ICAI SM)**

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

Answer:

She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding "control activities".

When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements.

It helps her in gaining insight into the internal control system of the company.

Question 9: **(ICAI SM)**

Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

Answer:

In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.

Question 10: **(ICAI SM)**

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.

Answer:

Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated.

It represents a "control deficiency".

Question 11: **(ICAI SM)**

Discuss how "analytical procedures" performed as "risk assessment procedures" can be useful to an auditor.

Answer:

1) **The risk assessment procedures shall include the following:**
   a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
   b) Analytical procedures.
   c) Observation and inspection.
2) **Analytical Procedures:**
   a) 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.
   b) Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, relationship between sales and square footage of selling space or volume of goods sold.
   c) 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.

d) 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.

e) 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.

Question 12: **(ICAI SM)**

Is materiality required to be documented by the auditor? What factors have to be considered this regard?

Answer:

The audit documentation shall include the following amounts and the factors considered in their determination:

a) Materiality for the financial statements as a whole

b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures

c) Performance materiality and

d) Any revision of (a)-(c) as the audit progressed

Question 13: **(ICAI SM)**

Discuss relationship between "General IT controls" and "application controls" in an automated environment.

Answer:

These two categories of control over IT systems are interrelated.

The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

Question 14: **(ICAI SM) / (RTP May 21) / (Nov 20)**

A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company.

Answer:

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:

a) Check completeness of data and population that is used in either test of controls or substantive audit tests.
b) Selection of audit samples - random sampling, systematic sampling.
c) Re-computation of balances - reconstruction of trial balance from transaction data.
d) Reperformance of mathematical calculations - depreciation, bank interest calculation.
e) Analysis of journal entries
f) Fraud investigation.
g) Evaluating impact of control deficiencies.

Question 15: **(ICAI SM)**

What is understood by "non-routine" transactions? Briefly outline why risks of material misstatement is greater for such transactions.

Answer:

1) 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.
2) Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.
3) Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assesses assertions affected by a significant risk as higher inherent risk.
4) The following are always significant risks:
   a) Risks of material misstatement due to fraud
   b) Significant transactions with related parties that are outside the normal course of business for the entity.

Question 16: **(ICAI SM)**

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

Answer:

1) The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.
2) Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It 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.
3) It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.
4) Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
5) 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.

Question 17: **(ICAI SM)**

"Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.

Answer:

1) **Definition of Risk of Material Misstatements:**
   SA 200 states that risk of material statement is the risk that the financial statements are materially misstated prior to audit. It simply means that there is a probability of frauds or errors in financial statements before audit.
2) **The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk.** Both inherent risk and control risk are the entity's risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client. These are entity's risks and are not influenced by the auditor.
3) **Inherent risk:**
   a) Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.

b) There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.

4) **Control risk:**

a) In accordance with SA-200, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

b) Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity.

Question 18: **(ICAI SM)**

"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

Answer:

1) Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement".
2) However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
3) The assessment of the risks of material misstatement may 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.
4) It can be concluded from the above that: **Audit risk = Risks of material misstatement X Detection risk**
5) Since risks of material misstatement is a function of inherent risk and control risk, it can also be shown as: **Audit risk = Inherent risk X Control risk X Detection risk**

Question 19: **(ICAI SM)**

"The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment.

Answer:

1) The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
   a) Management has created and maintained a culture of honesty and ethical behaviour and
   b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.
2) What is included in Control Environment? The control environment includes:
   a) the governance and management functions and
   b) the attitudes, awareness, and actions of those charged with governance and management.
   c) the control environment sets the tone of an organization, influencing the control consciousness of its people.

Question 20: **(ICAI SM)**

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.

Answer:

Objectives of Internal Control

1) Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives.
2) 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.
3) 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.
4) Objectives of Internal Control are :
   a) transactions are executed in accordance with managements general or specific authorization;

b) 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;

c) assets are safeguarded from unauthorised access, use or disposition; and

d) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Questions from PAST Exam / RTP / MTP (As Per OLD Syllabus)

Question 21: **(Nov 20)**

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.

Answer:

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:

a) The elements of the financial statements (Example - Assets, liabilities, equity, revenue, expenses);

b) 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)

c) 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;

d) 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;)

e) The relative volatility of the benchmark.

Question 22: **(Dec. 21)**

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.

Answer:

Risk of Material Misstatement – Greater for Significant Non-Routine Transactions:

1) 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.
2) Risks of Material Misstatement- Greater for Significant Non-Routine Transactions
3) 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.
4) **Keeping in view above, view of Auditor of Sunshine Ltd is correct.**

Question 23: **(Nov 20)**

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.

Answer:

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.

a) **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.

b) **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.

c) **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.

Question 24: **(Jul 21)**

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.

Answer:

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:

a) Are there any weaknesses in IT controls?

b) What is the impact of these weaknesses on overall audit?

c) Report deficiencies to management – Internal Controls Memo or Management Letter.

d) 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.

CHAPTER 4

AUDIT EVIDENCE

Case Study 1

CA Drishti Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties.

The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

In particular, she is attending physical inventory count process of the company at year end in accordance with requirements of SA 501.The inventory of the company includes raw materials consisting mainly of natural and dyed yarns, work in process in different stages of manufacturing and finished stocks of towels and bedspreads.

She is also planning sending confirmations to parties to whom the company has sold goods. On reviewing trade receivables list, she finds that the list also contains large number of parties having small balances. She further finds that these receivables have arisen due to sale of bedspreads to small time retailers and possibility of difference in balances as per company's records and as per records of these small-time retailers is low. Risk of misstatements in relation to trade receivables has been assessed as low. Besides, there is nothing to suggest that small-time retailers would disregard such requests.

While conducting audit, she is testing controls operating in the company. She is also conducting tests of various items of income and expenditure as well as balances appearing in balance sheet. She intends to rely upon sampling extensively.

Based upon above, answer the following questions:

1) Which of the following statements is most appropriate regarding inventory count by auditor in accordance with SA 501?
   a) She should inspect the inventory to ascertain its existence and condition at all locations, observe how company personnel are carrying out count procedures and perform test counting.
   b) She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.

c) She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.

d) She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.

2) As regards inventories lying with third parties, which of following statements meets requirements of SA 501?

a) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.

b) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.

c) There is no obligation cast upon an auditor in respect of inventories lying with third parties.

d) She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.

3) Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?

a) She should not plan and design confirmation requests for large number of parties having small balances.

b) She should plan and design positive confirmation requests for large number of parties having small balances.

c) She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate

d) She should plan and design negative confirmation requests for large number of parties having small balances.

4) As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?

a) Sampling is used in tests of transactions as well as tests of controls.

b) Sampling is used in tests of balances as well as tests of controls.
c) Sampling is used in tests of details.
d) Sampling is used in tests of details as well as tests of controls.

5) Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?
a) Sampling risk can be eliminated.
b) Increase in sampling risk would lead to decrease in detection risk.
c) Decrease in sampling risk would lead to increase in detection risk.
d) Sampling risk will always be in existence.

Answers to Case Study 1

1) a)
2) b)
3) d)
4) d)
5) d)

Case Study 2

Financial statements of a firm have been put up for audit before CA Manushi. On going through financial statements, she wants to verify assertions contained in financial statements and has planned certain procedures for carrying out detailed checking.

A. She plans to verify some major bills debited in "Machinery repair" account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.
B. She plans to verify that all balances appearing under trade payables are genuine and not fake.
C. She plans to compare amount of wages paid in current year and last year. It is also planned to verify relationship between the number of employees and wages paid in both years.
D. She is of the view that it is necessary to examine title deeds of "land" appearing in financial statements of the firm.
E. The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms.

Based on above, answer the following questions: -

1) As regards description given regarding verification of bills debited in "Machinery repair" account, identify what she intends to perform?
   a) Tests of Controls
   b) Tests of transactions
   c) Tests of balances
   d) Risk assessment procedures.

2) Identify which type of assertion she intends to focus when she wants to ensure genuineness of trade payables.
   a) Occurrence
   b) Cut-off
   c) Existence
   d) Accuracy

3) As regards comparison of wages of current year and last year and comparison of relationship between the number of employees and wages paid in both years, identify what she is trying to do?
   a) She is intending to perform tests of details.
   b) She is intending to perform tests of transactions.
   c) She is intending to perform tests of balances.
   d) She is intending to perform substantive analytical procedures.

4) In case of examination of title deeds of "land", which of the following fits into most appropriate description of such an audit procedure?
   a) Observation
   b) Inspection
   c) External confirmation
   d) Enquiry

5) She wants to verify whether conversion of foreign currency into Indian rupees is proper or not. Identify what she is trying to do?
   a) Reperformance
   b) Recalculation
   c) Observation
   d) Inspection

Answers to Case Study 2

1) b)
2) c)
3) d)
4) b)
5) b)

Independent MCQ's

1) Which of the following is not one of functions of internal auditor of an organization?
   a) Performing assurance activities
   b) Performing consulting activities to improve governance of organization
   c) Performing risk management activities
   d) Expressing independent opinion on financial statements of organization

2) An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?
   a) The risk that management may override controls in respect of related party transactions is lower.
   b) The risk that management may override controls in respect of related party transactions is higher.
   c) There is no effect on the risk that management may override controls in respect of related party transactions.
   d) Risk of overriding of controls by management has no relationship at all with related party transactions.

3) Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?
   a) Efficient conduct of business
   b) Safeguarding of assets
   c) Prevention and detection of frauds and errors
   d) Assessing audit risk

4) Which of the following is not an advantage of statistical sampling?
   a) Sample size does not increase in proportion to size of area tested.
   b) Sample selection is more objective.
   c) It provides a means of deriving a calculated risk and corresponding precision.
   d) In case of verifying compliance with specific legal requirements, it is suitable.

5) A company auditor receives external confirmation from an entity to whom company has sold goods. The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?
   a) It shows that said trade receivable exists.
   b) It shows that said trade receivable is properly valued.
   c) It shows that company has a right to said trade receivable.
   d) It shows that amount of said trade receivable has been recorded in proper account.

Answers to the MCQs based Questions:

1) d)
2) b)
3) d)
4) d)
5) b)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **Purchase invoice is an example of internal evidence.**

Ans: Incorrect: Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

2) **Sufficiency is the measure of the quality of audit evidence.**

Ans: Incorrect: Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

3) **Inquiry alone is sufficient to test the operating effectiveness of controls.**

Ans: Incorrect: Inquiry along with other audit procedures (for example observation, inspection, external confirmation etc.) would only enable the auditor to test the operating effectiveness of controls. Inquiry alone is not sufficient to test the operating effectiveness of controls.

4) **When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries.**

Ans: Incorrect: When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.

5) **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.

6) **The method which involves dividing the population into groups of items is knows as block sampling.**

Ans: Incorrect: The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

7) **Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.**

Ans: Incorrect: Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

8) **Non 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.**

Ans: Incorrect: 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.

9) **Sample need not be representative.**

Ans: Incorrect: 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.

10) **The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.**

Ans: Incorrect: 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.

11) When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.

Ans: Incorrect: 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.

12) Stratified Sampling is used for homogeneous population

Ans: Incorrect: Stratified sampling is used when the population is diversified i.e heterogeneous. The population is divided into sub population having similar characteristics. Sample are then chosen from these sub populations which are called as Stratum. Therefore, stratified sampling is not useful in case of homogeneous population.

13) Non statistical sampling is considered to be more scientific than the statistical sampling.

Ans: Incorrect: Statistical sampling uses scientific method of choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

14) In case of Statistical sampling, auditor's bias in choosing sample is involved.

Ans: Incorrect: Statistical sampling uses scientific method choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditor's judgment and past experience is used to choose samples without and scientific method. Hence, personal bias is involved in Non statistical sampling and not Statistical.

15) In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population.

Ans: Incorrect: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

16) Low acceptable sampling risk requires larger sample size

Ans: Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

17) 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 financial data only.

Ans: Incorrect: 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 nonfinancial data.

18) Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.

Ans: Incorrect: 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.

19) Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.

Ans: Incorrect: 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.

20) Analytical Procedures are required in the planning phase only.

Ans: Incorrect: 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.

21) Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.

Ans: Incorrect: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

22) Ratio analysis is useful in analyzing revenue and expense account only.

Ans: Incorrect: Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts

23) Reasonableness test rely only on the events of the prior period like other analytical procedures.

Ans: Incorrect: Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

24) The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.

Ans: Incorrect: Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013. The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.

Answer:

The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

Question 2: **(ICAI SM)**

CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

Answer:

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. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.

Question 3: **(ICAI SM)**

A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

Answer:

The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. 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.

Question 4: **(ICAI SM)**

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

Answer:

One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

Question 5: **(ICAI SM)**

CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.

Answer:

In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

Question 6: **(ICAI SM)**

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

Answer:

In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach nonstatistical 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 auditor cannot escape his responsibility in this regard.

Question 7: **(ICAI SM)**

The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?

Answer:

As per requirements of SA-501, 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, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

Question 8: **(ICAI SM)**

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well -functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

Answer:

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.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

Question 9: **(ICAI SM)**

On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer.

On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?

Answer:

In terms of requirements of SA 505, if management refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request.

Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.

Question 10: **(ICAI SM)**

An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues

Answer:

Analytical procedures in relation to revenue can include:- (i) Comparing revenue of current year with previous year and investigating significant fluctuations (ii) Comparing revenue of current year with budgeted targets and investigating significant fluctuations.

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Question 11: **(ICAI SM)**

The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

Answer:

There exists a very important relationship between Audit Evidence and opinion of the Auditor. While conducting an audit of a company, the auditor obtains audit evidence and with the help of that audit evidence obtained, the auditor forms an audit opinion on the financial statements of that company.

Question 12: **(ICAI SM)**

An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted. Give your views as auditor of Genuine Limited.

Answer:

Audit evidence obtained externally is more appropriate from reliability point of view as compared to those which are obtained internally. The reason that audit evidence obtained externally is more appropriate from the point of view of reliability is that there is a very low risk that they can be altered or changed.

Question 13: **(ICAI SM)**

There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

Answer:

Sufficiency and Appropriateness of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

Question 14: **(ICAI SM)**

While auditing the books of accounts of AB Limited for the financial year 2022-23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

Answer:

The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

Question 15: **(ICAI SM)**

JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements. Required Suggest the audit procedures in the given case.

Answer:

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.

Question 16: **(ICAI SM)**

Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements. Required Suggest the auditor with reference to SAs

Answer:

1) 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; and
   c) Reviewing legal expense accounts.
2) 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.

Question 17: **(ICAI SM)**

During the financial year 2022-23, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was ₹ 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of ₹ 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

Answer:

The above-mentioned situation is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

Question 18: (ICAI SM)

While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request. Required How would the auditor proceed?

Answer:

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

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

(b) 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

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

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

Question 19: (ICAI SM)

CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to ₹50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of ₹ 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

Answer:

1) If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid ₹ 50,000/- per month as rent and the same is getting reflected in the rent agreement.

2) Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.
3) If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.
4) However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

Question 20: **(ICAI SM)**

Analytical procedure involves analysis of relationship among financial and nonfinancial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2022-23.

Answer:

1) As per **SA 520, Analytical Procedures** means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
2) The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.
3) The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states.
4) He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories. i.e. Total wages = Wages per worker x Total number of workers. Here wages per worker is financial data i.e. in ₹ and total number of workers is a number which is a non financial data.
5) Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in ₹) by analyzing the relationship between wages per worker (in ₹) which is financial data and number of workers which is a non financial data.
6) Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

Question 21: (ICAI SM)

Many related party transactions are in the normal course of business. 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. Give few examples of such areas.

Answer:

1) 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.
2) 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.
3) **For example**
   a) 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.
   b) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
   c) 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.

Question 22: (ICAI SM)

An auditor is appointed for the first time for audit of accounts of an entity. The accounts of previous year were unaudited. He is unable to obtain sufficient appropriate audit evidence regarding the opening balances. What is his responsibility in this regard?

Answer:

Reporting by the auditor with regard to opening balances

1) If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.
2) If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

Question 23: **(ICAI SM)**

Discuss some of circumstances when work of the internal auditor cannot be used by external auditor.

Answer:

The external auditor shall not use the work of the internal audit function if the external auditor determines that:

a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
b) The function lacks sufficient competence; or
c) The function does not apply a systematic and disciplined approach, including quality control.

Question 24: **(ICAI SM)**

Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors.

Answer:

1) An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction.
2) Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.
3) It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.
4) Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use.
5) Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem.

6) Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can help entities in their regular system operations. However, audit trails involve costs.
7) The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails. Systems which have a feature of audit trail inspires confidence in auditors.
8) It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it.
9) Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

Question 25: **(ICAI SM)**

Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

Answer:

1) 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.
2) 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.
3) Analytical procedures in planning the audit use both financial data and nonfinancial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.
4) 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.

Question 26: **(ICAI SM)**

Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.

Answer:

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:

a) Opening balances contain misstatements that materially affect the current period's financial statements; and

b) 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.

Question 27: **(ICAI SM)**

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?

Answer:

1) Initial audit engagement is an engagement in which either:
   a) The financial statements for the prior period were not audited; or
   b) The financial statements for the prior period were audited by a predecessor auditor.
2) 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.**
3) 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.
4) 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.

Question 28: **(ICAI SM)**

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?

Answer:

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

1) **Trend analysis:**
   a) 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.
   b) 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.
2) **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.
3) **Reasonableness tests:**
   a) 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).
   b) 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.

4) **Structural modelling:**
   a) 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).
   b) The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

Question 29: **(ICAI SM)**

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.

Answer:

1) 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.
2) 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.
3) **Example**
   a) 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.
   b) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
   c) 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.

Question 30: **(ICAI SM)**

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.

Answer:

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.

Question 31: (ICAI SM)

Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

Answer:

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

a) Nature of inventory.
b) Stages of completion of work in progress.
c) The risks of material misstatement related to inventory.
d) The nature of the internal control related to inventory.
e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
f) The timing of physical inventory counting.
g) Whether the entity maintains a perpetual inventory system
h) 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
i) Whether the assistance of an auditor's expert is needed.

Question 32: (ICAI SM)

The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on "Analytical Procedures"?

Answer:

As per **SA 520- "Analytical Procedures"** If while applying analytical procedures in accordance with SA 520, the statutory auditor identifies 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:

a) 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.

b) 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.

In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. and obtain sufficient and appropriate audit evidence relevant to management response.

Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

Question 33: (ICAI SM)

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain

Answer:

Audit evidence is necessary to support the auditor's opinion and report.

1) 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.

2) 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.

3) Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.

4) 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.
5) 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, reperformance and analytical procedures, often in some combination, in addition to inquiry.
6) 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.
7) 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.

Question 34: **(ICAI SM)**

What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

Answer:

1) The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.
2) Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:
   a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
   b) 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;
   c) 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

d) 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.

3) 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.

4) 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.

Question 35: **(ICAI SM)**

Define Analytical Procedures

Answer:

Meaning of Analytical Procedures:

1) As per the **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.

2) 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. Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

Question 36: **(ICAI SM)**

M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2022-23-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

Answer:

As per **SA 510, "Initial Engagement- Opening balances"** the objective of the auditor with respect to the opening balances is to obtain sufficient and appropriate audit evidence about whether:

a) Opening balances contain misstatements that materially affect the current period's financial statements; and

b) 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.

Question 37: (ICAI SM)

What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.

Answer:

1) **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.
2) **Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:**
   a) **Materiality:** It 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.
   b) **Risk of material misstatement:** It 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:
      (i) **Inherent risk:** The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
      (ii) **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.
   c) **Size of a population:** It 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.

Question 38: **(ICAI SM)**

What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".

Answer:

Meaning of Audit Sampling:

1) **"Audit Sampling"** means 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.
2) The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.
3) Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.

Methods of Sampling

1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below-
   a) **Simple Random Sampling:**
      (i) Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
      (ii) Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum).
      (iii) Today random numbers are also generated using various applications on the cellphones like the random number generator. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range.
   b) **Stratified Sampling:**
      (i) This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

(ii) Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum.

(iii) The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

2) **Interval Sampling or Systematic Sampling:**

a) Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

b) Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

c) When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

3) **Monetary Unit Sampling:**

It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

4) **Haphazard sampling:**

a) Haphazard selection, in which the auditor selects the sample without following a structured technique.

b) Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection.

c) Haphazard selection is not appropriate when using statistical sampling.

5) **Block Sampling:**

a) 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.

b) 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.

c) Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once.

Question 39: **(ICAI SM)**

With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Answer:

1) **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
2) **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.
3) **Sample Size:** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
4) **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.

Question 40: **(ICAI SM)**

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

Answer:

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-

a) 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.

b) 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 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.

Question 41: **(ICAI SM)**

Write short notes on the following:

a) Advantages of Statistical sampling in Auditing.

b) Stratified sampling

Answer:

a) **Advantages of Statistical sampling in Auditing.**

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective. 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.
6) It 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.

b) **Stratified Sampling:**

1) This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

2) Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum.
3) The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
4) The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.
5) Stratification means dividing heterogeneous (Diversified) population into Homogeneous (having similar characteristics) sub population, where samples are drawn from each sub population.
6) Therefore, we can say that random selection method is applied through random number generators, for example, random number tables.

Question 42: **(ICAI SM)**

What precautions should be taken by the auditor while applying test check techniques?

Answer:

Precautions to be taken while applying test check techniques are

1) Thorough study of accounting system should be done before adopting sampling.
2) Proper study of internal control systems.
3) Areas which are not suitable for sampling should be carefully considered. Eg: compliance with statutory provisions, transactions of unusual nature etc.
4) Proper planning for Sampling methods to be used and explaining the staff,
5) Transactions and balances have to be properly classified (stratified)
6) Sample size should be appropriately determined.
7) Sample should be chosen in unbiased way, • Errors located in the sample should be analysed properly.

Question 43: **(ICAI SM)**

Explain the factors to be considered while determining the extent of checking on a sampling plan.

Answer:

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

1) Size of the organisation under audit.
2) State of the internal control.
3) Adequacy and reliability of books and records.
4) Tolerable error range.
5) Degree of the desired confidence.

Questions from PAST Exam / RTP / MTP (As per OLD Syllabus)

Question 44: **(Jul 21)**

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.

Answer:

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.

Question 45: **(Nov 20)**

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?

Answer:

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-

a) Inquire as to management's reasons for the refusal and seek audit evidence as to their validity and reasonableness.

b) 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

c) Perform alternative audit procedures designed to obtain relevant and reliable evidences.

d) 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.

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

Question 46: **(RTP May 22)**

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.

Answer:

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:

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; and
c) Reviewing legal expense accounts.

Question 47: **(MTP Mar 21)**

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.

Answer:

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:

a) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
b) 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.
c) 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).
d) 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).

e) 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.

Question 48: **(MTP April 22)**

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?

Answer:

Other examples of situations where external confirmations may be used include the following:

a) Inventories held by third parties at bonded warehouses for processing or on consignment
b) Property title deeds held by lawyers or financiers for safe custody or as security
c) Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date
d) Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
e) Accounts payable balances and terms
f) Long outstanding share application money.

Question 49: **(MTP Nov 21)**

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.

Answer:

1) 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.

2) 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.

3) 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:
   a) Evaluate the competence, capabilities and objectivity of that expert;
   b) Obtain an understanding of the work of that expert; and
   c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Notes:

CHAPTER 5

AUDIT OF ITEMS OF FINANCIAL STATEMENTS

Case Study

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2022-23. R K Maheshwari & Associates are the statutory auditors of the company since the year 2020-21. The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.

The company raised fresh capital of ₹ 5 Cr during the FY 2022-23. The shares with the nominal value of ₹ 10 per share were issued at a premium of ₹ 5 per share.

The company has the Reserves and Surplus totaling to ₹ 2 Cr, comprising of securities premium and general reserve.

CA Raman directed CA Madhu to verify the issue of the share capital in detail giving special consideration to the utilization of the securities premium amount.

The audit engagement team discussed with the management about the performance of the company during the year under consideration. To this, the management told the engagement team that the company is performing very well and the company has doubled its revenue during the year as compared to the last year. The management of the company also told the auditors that during the year the company has made majority of its sales on credit basis to its customers.

CA Raman directed Mr. Aman to send balance confirmation requests to debtors having balance in excess of ₹ 1 lakh.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process. The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

a) Current maturities to long term borrowings
b) Long term maturities of finance lease obligations
c) Interest accrued but not due on borrowings
d) • Interest accrued and due on borrowings

Based upon above, answer the following questions:

1) Which of the following is not correct with respect to shares issued at premium and securities premium account in terms of Section 52 of the Companies Act, 2013?
   a) 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.
   b) The securities premium account can be applied by the company in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares.
   c) The securities premium account cannot be applied by the company in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company.
   d) The securities premium account can be applied by the company for the purchase of its own shares or securities under section 68.

2) Which of the following is not an example of capital reserve?
   a) Revaluation reserve arising from revaluation of fixed assets
   b) Securities Premium
   c) Capital redemption reserve
   d) General reserve

3) Statement 1: Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client.
   Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances.
   a) Only statement 1 is correct
   b) Only statement 2 is correct
   c) Both statements 1 & 2 are correct
   d) Both statements 1 & 2 are incorrect

4) Mr. Chetanya performed which of the following analytical procedures to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?
   a) Consumption Analysis
   b) Stock Composition Analysis
   c) Reasonableness test
   d) Ratio analysis

5) Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act 2013?
   a) Current maturities of long term borrowings is to be disclosed under the head long term borrowings
   b) Long term maturities of finance lease obligations is to be disclosed under the head long term borrowings
   c) Interest accrued but not due on borrowings is to be disclosed under the head Other Current Liabilities
   d) Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities

Answers to Case Study 1

1) c)
2) d)
3) c)
4) b)
5) a)

Independent MCQ's

1) An auditor is verifying purchases to ensure their genuineness. Consequently, he is also trying to verify that no fake "trade payables" are present in financial statements. Which assertions concerning purchase transactions and trade payables respectively are being verified by auditor?
   a) Occurrence; Existence
   b) Occurrence; Completeness
   c) Existence; Occurrence
   d) Completeness; Occurrence

2) Which of the following statement is most appropriate as regards to disclosure of goods in transit in financial statements of a company?
   a) No separate disclosure of goods in transit is required.
   b) Disclosure of total goods in transit under head of inventories is required.
   c) Disclosure of goods in transit under each sub-head of inventories is required.
   d) Disclosure of goods in transit for raw material and finished goods is required.

3) Sweat Equity shares are issued by a company at a discount or for consideration other than cash to its:-
   a) Directors only
   b) Clients only
   c) Directors or employees
   d) Auditors only

4) Which of the following is not an element of cost of an item of machinery included under head "Property, Plant and Equipment"?
   a) Installation costs
   b) Freight cost of bringing the item to its location
   c) Inaugural costs
   d) Employee benefit cost for making such an item suitable for production

5) Which of the classification is not required by a company in respect of its "Cash and cash equivalents?"
   a) Balance with Banks
   b) Balance with scheduled banks
   c) Cash on hand
   d) Cheques on hand

Answers to the MCQs based Questions:

1) a)
2) c)
3) c)
4) c)
5) b)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.**

Ans: Incorrect: Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, postemployment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

2) **Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.**

Ans: Incorrect: 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) **"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.**

Ans: Incorrect: "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

4) **Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.**

Ans: Incorrect: Revenue reserves represent profits that are available for distribution to shareholders.

5) **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.**

Ans: Correct: 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.

6) If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.

Ans: Incorrect: If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume that the management has claimed/ asserted that:

a) The building recognized in the balance sheet exists as at the periodend (existence assertion);
b) Company X owns and controls such building (Rights and obligations assertion);
c) The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
d) All buildings owned and controlled by Company X are included within the carrying amount of ₹ 100 lakh (Completeness assertion).

7) The securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares.

Ans: Incorrect: 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, any issue of shares or debentures of the company;
d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
e) for the purchase of its own shares or other securities under section 68.

8) Material and wages are considered to be revenue expenditure when incurred for construction of building.

Ans: Incorrect: Material and Wages incurred on construction of building qualify to be capital expenditure as per AS 10 "Property, Plant and Equipment". Therefore, these have to be added to the cost of the asset i.e building and shall not be expensed off to Statement of Profit and Loss.

9) PPE are depreciated when the asset is actually put to active use.

Ans: Incorrect: Depreciation is a fall in value of asset due to obsolescence, 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.

10) Increase in authorised capital of the company requires special resolution to be passed at the general meeting.

Ans: Incorrect: Increase in Authorised capital requires alteration of capital clause of memorandum of Association. Therefore, ordinary resolution is passed for increase in authorised capital of the company as per the Companies Act, 2013.

11) Capital redemption reserve can be used for distribution of dividends

Ans: Incorrect: Capital Redemption reserve is not a free reserve. It is a restrictive reserve and can be used only for purposes given in the Act. Since it is not a free reserve, it cannot be utilised for payment of dividends. CRR can be used only for the purpose of issuing fully paid up bonus shares.

12) Dividends are recommended by the Board, and declared by the Shareholders.

Ans: Correct: The dividends are recommended by the Board of Directors by passing a resolution at the board meeting. The Shareholders declare the dividends at the AGM by passing an ordinary resolution. Declaration of dividend is an item of ordinary business. However, the shareholders can decrease the amount of dividends recommended by the board but cannot increase it.

13) In verifying Trade Receivables balance, Direct Confirmation Procedure is one of the important audit activity.

Ans: Correct: While auditing trade receivable balance, direct confirmations as per SA 505, is considered to be the most important audit activity. Direct confirmation can be sought from the debtors directly confirming their balance due. The replies to the confirmation can be then matched with the records maintained by the client. Any discrepancies so revealed, can be investigated and checked in detail for possibility of any risk of material misstatement. Auditor selects few debtors' balances and ask the client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

Answer:

The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company.

This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

Question 2: **(ICAI SM)**

A company has availed cash credit facility of ₹ 2 crore (O/s balance ₹ 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

Answer:

It shall be shown under the head **"Borrowings"** and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading **"Loans repayable on Demand"** from Banks.

As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

Question 3: **(ICAI SM)**

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

Answer:

A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

Question 4: **(ICAI SM)**

An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.

Answer:

Substantive analytical procedures in respect of sales will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

Question 5: **(ICAI SM)**

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of deprecation by company proper in its books?

Answer:

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

Question 6: **(ICAI SM) / (Nov 20)**

How will you vouch and/or verify the following:

a) Goods sent out on Sale or Return Basis.

b) Borrowing from Banks.

Answer:

a) **Goods Sent Out on Sale or Return Basis:**

(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.

(iv) 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.

b) **Borrowing from Banks:**

Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-

(i) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened. Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

Question 7: **(ICAI SM)**

How will you vouch/verify the following:

a) Goods sent on consignment.

b) Foreign travel expenses.

c) Receipt of capital subsidy.

d) Provision for income tax.

Answer:

a) **Goods Sent on Consignment:**

(i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.

(ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown separately under the head inventories.

b) **Foreign Travel Expenses:**

(i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.

(ii) Verify that the tour programme was properly authorised by the competent authority.

(iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.

(iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.

(v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

c) **Receipt of Capital Subsidy:**

(i) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

d) **Provision for Income Tax:**

(i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.

(ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.

(iv) Compute tax payable as per the latest applicable rates in the Finance Act.

(v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.

(vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

Question 8: **(ICAI SM)**

How will you vouch and/or verify payment of taxes?

Answer:

Vouching of Payment of Taxes:

1) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
2) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
3) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.
4) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
5) The entity 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. This should be checked by the auditor.
6) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

Question 9: **(ICAI SM)**

How would you vouch/verify the following:

a) Advertisement Expenses.

b) Sale of Scrap.

Answer:

a) **Advertisement Expenses:**

(i) Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.

(ii) See that the advertisement relates to client's business.

(iii) Inspect the receipt issued by the agency.
(iv) Ascertain the nature of expenditure - revenue or capital expenditure and see that it has been recorded properly.
(v) Ascertain the period for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.
(vi) See that all outstanding advertisement bills have been provided for.

b) **Sale of Scrap:**

(i) Review the internal control as regards generation, storage and disposal of scrap.
(ii) Check whether the organization is maintaining reasonable record for generation of scrap.
(iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
(iv) Check the rates at which scrap has been sold and compare the rate with previous year.
(v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
(vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
(vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

Question 10: **(ICAI SM)**

ABC Ltd. has issued shares for cash at a premium. 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.

Answer:

Shares Issued at Premium:

1) 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.
2) As per the section, where a company issue 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.

3) **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, any issue of shares or debentures of the company;
   d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
   e) for the purchase of its own shares or other securities under section 68.
4) 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

Question 11: **(ICAI SM)**

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.

Answer:

1) In addition to the procedures undertaken for verifying completeness of additions to PPE during the 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.
2) 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.
3) The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.
4) 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.
5) 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.

Question 12: **(ICAI SM)**

Write the audit Procedure for verification of existence of Trade Receivables.

Answer:

For Verification of Existence of Trade Receivables, the auditor should check the following:

1) 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 ageing report and trace the balance as per the report to the general ledger.
2) Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoicewise and on FIFO basis i.e. previous bill is adjusted first.
3) If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
4) 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.
5) 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.
6) 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.
7) Where no reply is received, the auditor should perform alternate procedures regarding the balances.
8) Agreeing the balance to cash received subsequently;
9) 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)
10) 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.
11) Check that receivables for other than sales or services are not included in the list.
12) 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.

Question 13: **(ICAI SM)**

MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2021-22. During the course of audit, one of the audit team members, Mr. Viaan noticed that the company has made loans totaling to ₹ 50 lakhs to the promoters of the company, namely, Mr. Raj and Mr. Rajeev without specifying the period of repayment. Mr. Viaan discussed with Mr. Manik, the engagement partner, about the disclosure requirements with respect to such loans required by Schedule III to the Companies Act, 2013. What should Mr. Manik advise Mr. Viaan?

Answer:

Mr. Manik should advise Mr. Viaan to consider whether the following disclosures as required by Schedule III to the Companies Act, 2013, has been made in respect of the loans granted to promoters, namely, Mr. Raj and Mr. Rajeev, either severally or jointly with any other person, that are:

a) repayable on demand or

b) without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

Question 14: **(ICAI SM) / (Dec 21)**

What are the disclosures requirements as per Part I of Schedule III to the Companies Act with respect to the cash & cash equivalents held by a company?

Answer:

Disclosure of Cash & Cash Equivalent in the Financial Statements:

The following are the disclosure requirements as per Schedule III to the Companies Act, 2013, with respect to the cash & cash equivalents held by the company:

(i) Cash and cash equivalents shall be classified as:

- **a)** Balances with banks;
- **b)** Cheques, drafts on hand;
- **c)** Cash on hand;
- **d)** 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.

Question 15: **(ICAI SM)**

Mercury Ltd. is a company engaged in the manufacture of floor mats. The company sells its goods on credit. The debtors balance as on 31.03.2022 amounted to ₹ 20 cr. What is the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company?

Answer:

The following are the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company:

Trade Receivable ageing schedule (Table 1)

Particulars	Outstanding for following periods from due date of payments					
	Less than 6 Months	6 Months - 1 Year old	1-2 Years	2-3 Years	More than 3 Years	Total
(i) Undisputed TR - Considered Good.						
(ii) Undisputed TR - Considered Doubtful.						
(iii) Disputed TR - Considered Good.						
(iv) Disputed TR - Considered Doubtful						

Question 16: **(ICAI SM)**

You are the statutory auditor of Jupiter Ltd. for the FY 2022-23. During the course of audit, you noticed that the company has PPE under construction i.e. Capital Work in Progress. What disclosures should the company give with respect to the ageing schedule of such capital work in progress as required by Schedule III to the Companies Act, 2013?

Answer:

Capital-Work-in Progress

a) For Capital-work-in progress, following ageing schedule shall be given:

CWIP ageing schedule

CWIP	Amount in CWIP for a period of				Total
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years	
Projects in Progress					
Projects temporarily suspended					

*Total shall tally with CWIP amount in the balance sheet.

b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given:**

CWIP	To be completed in			
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately.

Question 17: (ICAI SM)

The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. What audit procedures should the statutory auditor of the company perform?

Answer:

The statutory auditor of Saturn Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023.

The auditor should:

a) vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).

b) evaluate the consigned goods.

c) examine client correspondence, sales and receivables records, purchase documents.
d) determine existence of collateral agreements.
e) review consignment agreements.
f) review material purchase commitment agreements.
g) examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
h) obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

Questions from PAST Exam/ RTP / MTP (As per OLD Syllabus)

Question 18: **(Dec 21)**

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.

Answer:

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.

Question 18: **(Dec 21)**

Profit 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?

Answer:

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.

Question 19: **(July 21)**

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?

Answer:

CA X, having doubts about fictitious sales being recorded by Joyful Ltd would ensure that revenue is not overstated by performing following audit procedures:

a) Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.
b) Test check few invoices with their relevant entries in sales journal.
c) Obtain confirmation from few customers to ensure genuineness of sales transaction
d) Whether any fictitious customers and sales have been recorded.
e) Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
f) Whether unearned revenue recorded as earned.
g) Whether any substantial uncertainty exists about collectability
h) Whether customer obligations are contingent on other actions (financing, resale etc.)

Question 20: **(July 21)**

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.

Answer:

1) 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.
2) 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.
3) The auditor should:
   a) Verify that the entity has charged amortization on all intangible assets;
   b) 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.
4) The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired.
5) 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.

Question 21: **(Jan 21)**

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 amortisation expense.

Answer:

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:

a) Obtain the understanding of entity's accounting policy related to depreciation and amortisation.

b) Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.

c) Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.

d) Whether depreciation and amortisation charges are valid.

e) Whether depreciation and amortisation charges are accurately calculated and recorded.

f) Whether all depreciation and amortisation charges are recorded in the appropriate period.

g) Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.

h) Whether the most appropriate depreciation method for each separately depreciable component has been used.

Question 22: **(Jan 21)**

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.

Answer:

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:

a) Ascertain how the various stages of production/ value add are measured and in case estimates are made, understand the basis for such estimates.

b) 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.

c) Ensure that material costs exclude any abnormal wastage factors.

Question 23: (Jan 21)

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.

Answer:

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:
   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; and
   c) 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.

Question 24: (Jan 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'.

Answer:

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:

1) **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.
2) **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 accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.
3) 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.
4) 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.
5) 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 not constitute 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.

Question 25: **(Nov 20)**

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?

Answer:

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.

Question 26: **(RTP Nov 20)**

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.

Answer:

Direct confirmation procedure

1) 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.
2) 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.
3) 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:
   a) Agreeing the balance to bank statement received by the Company or internet / online login to account in auditor's personal presence;
   b) Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Notes:

CHAPTER 6

AUDIT DOCUMENTATION

Case Study

CA Rajan Pillai is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation:

A) Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).

B) The team has determined materiality for financial statements as a whole.

C) The team has assessed risks of material misstatements to be low.

D) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.

E) During the course of audit, many related party transactions have come to notice.

On the basis of above, answer the following questions:

1) Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues. Which of the following statements is most appropriate in this regard relating to audit documentation?

   a) Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.

   b) Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.

   c) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.

   d) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.

2) As regards materiality, which of the following statements is most appropriate in context of audit documentation?

   a) Materiality has already been determined. There is no need to put it into working papers.

b) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.

c) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.

d) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.

3) As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?

a) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.

b) Details of risk assessment procedures have to be documented.

c) Details about how understanding of each component of internal control was obtained has to be documented.

d) Precise calculation of risk of material misstatements has to be documented.

4) CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?

a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.

b) Detail of test counting undertaken should form part of audit documentation.

c) Detail of obsolete goods found should form part of audit documentation.

d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.

5) As regards related party transactions, which of the following should not be part of audit documentation?

a) Management representation letter in this regard

b) Related party transaction policy of the company

c) Documentation to show that such transactions are at arm's length basis

d) Documentation to show that such transactions are at close length basis.

Answers to Case Study:

1) c)
2) c)
3) d)
4) d)
5) d)

Independent MCQ's

1) Which of the following statement is appropriately suited to preparation of audit documentation?
   a) Audit documentation has to be prepared simultaneously as audit progresses.
   b) Audit documentation has to be prepared 60 days after date of audit report.
   c) Audit documentation has to be prepared when information is required by regulator.
   d) Audit documentation has to be prepared 60 days after completion of audit work.

2) Audit documentation is owned by:
   a) Client
   b) Auditor
   c) Team member responsible for documentation
   d) Regulator

3) Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?
   a) Previous years audited financial statements
   b) Projected cash flow statement for next twelve months provided by management in support of going concern assumption
   c) Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers
   d) Statement showing verification of ageing of trade receivables as on date of balance sheet.

4) Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?
   a) Evaluation of objectivity and competence of internal auditor has to be documented.

b) Nature of work used and reason for relying upon work used forms part of documentation.

c) Documentation on whether quality control is exercised in internal audit work forms part of audit documentation.

d) Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation.

Answers to the MCQs based Questions:

1) a)
2) b)
3) c)
4) d)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor.**

Ans: Incorrect: As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

2) **Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit.**

Ans: Incorrect: SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

Answer:

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

Question 2: **(ICAI SM)**

CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file.

The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

Answer:

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.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

Question 3: (ICAI SM)

The form, content and extent of audit documentation depends upon number of factors. List out any four such factors.

Answer:

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.

Question 4: (ICAI SM)

Discuss any two purposes of audit documentation.

Answer:

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.

Question 5: **(ICAI SM)**

Define audit documentation. Also give some examples.

Answer:

1) 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.)
2) Audit Documentation include:
   a) Audit programmes.
   b) Analyses.
   c) Issues memoranda.
   d) Summaries of significant matters.
   e) Letters of confirmation and representation.
   f) Checklists.
   g) Correspondence (including e-mail) concerning significant matters.

Question 6: **(ICAI SM)**

"Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.

Answer:

1) 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-
   a) the significant matters identified during the audit and
   b) how they were addressed.
2) Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.
3) 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.

Questions from PAST Exam / RTP / MTP (As per OLD Syllabus)

Question 7: **(July 21)**

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.

Answer:

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:

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

Question 8: **(RTP May 21) / (MTP March 21)**

Audit documentation serves a number of purposes. List such purposes.

Answer:

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.

Notes:

CHAPTER 7

COMPLETION AND REVIEW

Case Study

CA. Gaurav Gogoi is about to conclude audit of a company. It has been noticed during the course of audit that there is shortage of important raw material supplies being imported from China due to prevailing geo-political situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter.

The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate.

Besides, he also wants to be sure that all subsequent events till now have been considered and accounted for, where ever necessary, in financial statements.

Before concluding audit, he requests written representations from management regarding its responsibilities. However, it is noticed that such written representations provided by management use qualifying language.

He has also communicated significant findings from audit in writing with those charged with governance in the company and has retained copy of relevant mails. Besides, there are certain matters which were communicated by him orally from time to time during the course of audit to those charged with governance.

Based upon above, answer the following questions:

1) As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?
   - **a)** The auditor should express an unmodified opinion.
   - **b)** The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
   - **c)** Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.
   - **d)** Such an issue does not affect auditor's opinion.

2) As regards going concern basis of accounting is concerned, which of the following statements is true?
   a) A company showing net loss in its financial statements is essentially not a going concern.
   b) Following going concern assumption of accounting is primary duty of auditor.
   c) In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.
   d) Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.

3) Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?
   a) There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.
   b) There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.
   c) The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.
   d) The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.

4) As regards use of qualifying language in written representations, which of the following statement is most appropriate?
   a) It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
   b) Written representations should be unconditional. Such a wording is not acceptable.
   c) Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.
   d) Qualifying language in written representations is compulsory.

5) As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?
   a) Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.
   b) Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.

c) Matters communicated orally need not be put into writing. It is not practically feasible.

d) Matters communicated orally have to be documented by the auditor stating to whom these were communicated.

Answers to Case Study:

1) c)
2) c)
3) d)
4) a)
5) a)

Independent MCQ's

1) An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?
   a) Evaluation of adequacy of communication process is required on part of the auditor.
   b) Planned scope and timing of audit has also to be communicated.
   c) Communication of rationale behind audit procedures is necessary.
   d) Significant difficulties encountered during audit, if any, have to be communicated.

2) Written representations are: -
   a) Necessary audit evidence
   b) Sufficient appropriate audit evidence
   c) Not audit evidence
   d) Audit evidence depending upon auditor's professional judgment

3) Which of the following is false regarding communication of misstatements identified during course of an audit?
   a) The auditor should request those charged with governance for correction of identified misstatements.
   b) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.

c) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.

d) The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

4) Which of the following is not an example of subsequent event?

a) Event occurring between date of financial statements and date of auditor's report.

b) Event occurring on date of financial statements.

c) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.

d) Event occurring during course of performing audit procedures after date of financial statements.

5) Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?

a) Adverse key financial ratios

b) Inability to invest in modernisation of plant

c) Inability to pay creditors on time

d) Inability to pay salary of staff

Answers to the MCQs based Questions:

1) c)
2) a)
3) b)
4) b)
5) b)

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss, how, CA PK Jacob should proceed to deal with above issue.

Answer:

1) In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore.
2) It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.
3) He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

Question 2: **(ICAI SM)**

CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation? Also, discuss the rationale of doing so.

Answer:

1) She has already performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings after date of financial statements and going through books after date of financial statements.

2) Now, she should request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.
3) The rationale of obtaining written representations is that even after performing abovesaid procedures, she may not come to know all subsequent events.
4) Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Question 3: **(ICAI SM)**

During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages. Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company. How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditor in such a situation?

Answer:

1) Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.
2) In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash.
3) Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.

4) The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast.
5) The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

Question 4: **(ICAI SM)**

You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs.10 lacs paid on import of machinery was charged to statement of profit and loss. Discuss, how you should, proceed and communicate in above situation before signing audit report.

Answer:

The instances highlighted in above situation are examples of misstatements identified during the audit.

1) Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.
2) The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements.
3) In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate.
4) Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

Question 5: **(ICAI SM)**

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?

Answer:

The view of management is not proper.

1) Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities.
2) This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.
3) In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

Question 6: **(ICAI SM)**

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories. He points it out to the management in a one-liner as under: - "Physical verification of inventories is not being conducted at regular intervals as stipulated by management." Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

Answer:

1) While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication. Therefore, the above communication is not proper.
2) Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management.
3) It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company.
4) Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

Question 7: **(ICAI SM)**

List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency"

Answer:

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

1) The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
2) The susceptibility to loss or fraud of the related asset or liability.
3) The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
4) The financial statement amounts exposed to the deficiencies. • The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
5) The importance of the controls to the financial reporting process, for example:
   a) General monitoring controls (such as oversight of management).
   b) Controls over the prevention and detection of fraud.
   c) Controls over the selection and application of significant accounting policies.
   d) Controls over significant transactions with related parties.
   e) Controls over significant transactions outside the entity's normal course of business.
   f) Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
6) The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
7) The interaction of the deficiency with other deficiencies in internal control.

Question 8: **(ICAI SM)**

In what ways an effective two-way communication between auditor and those charged with governance is important?

Answer:

Communication from auditor is important with those charged with governance. An effective two-way communication is important in assisting:

1) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.
2) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
3) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

Question 9: **(ICAI SM)**

The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. It asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such a scenario?

Answer:

Implications for the auditor's report

1) **If use of Going concern basis of accounting is inappropriate:**
   If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.
2) **If use of going concern basis of accounting is appropriate but a material uncertainty exists**
   a) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements
      If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:
      (i) Draw attention to the note in the financial statements that discloses such matters.
      (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

(i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

3) **Management unwilling to make or extend its assessment:**

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. In such a situation, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

Question 10: **(ICAI SM)**

Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

Answer:

The audit documentation shall include: -

a) The amount below which misstatements would be regarded as clearly trivial;

b) All misstatements accumulated during the audit and whether they have been corrected; and

c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

Question 11: **(ICAI SM)**

Discuss meaning of "Date the financial statements are issued" under SA 560.

Answer:

1) It reflects the date that the auditor's report and audited financial statements are made available to third parties.

2) The date the financial statements are issued generally depends on the regulatory environment of the entity.

3) In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority.
4) Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

Questions from PAST Exam/ RTP / MTP (As per OLD Syllabus)

Question 12: **(July 21)**

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 requires adjustment of, or disclosure in, the financial statements have been identified. With reference to SA 560, what are the audit procedures included in the auditor's risk assessment?

Answer:

1) **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.
2) The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.
3) 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.
4) 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.

Question 13: **(RTP Nov 21)**

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events

Answer:

1) SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.
2) Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:
   a) Those that provide evidence of conditions that existed at the date of the financial statements; and
   b) Those that provide evidence of conditions that arose after the date of the financial statements.
3) SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.
4) Subsequent events refer to events occurring between the date of the 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.

Question 14: **(Jan 21)**

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?

Answer:

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:

a) 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.

b) 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.

c) 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.

Question 15: **(RTP Nov 21)**

While doing audit of ABC Pvt. Ltd., on the basis of sufficient and appropriate evidence, auditor comes to a conclusion that use of the Going Concern Basis of Accounting is appropriate, but a material uncertainty exists. Discuss the implications for auditor's report if:

a) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements

b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

Answer:

Use of the Going Concern Basis of Accounting is Appropriate but a Material Uncertainty Exists

The identification of a material uncertainty is a matter that is important to users' understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.

1) **Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements**
If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern."

2) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

a) Express a **qualified opinion or adverse opinion**, as appropriate, in accordance with SA 705 (Revised); and

b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Question 16: **(RTP Nov 21)**

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.

Answer:

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:

a) 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

b) 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.

Question 17: **(Jan 21)**

Explain the objectives of the auditor regarding written representations.

Answer:

The objectives of the auditor regarding written representation:

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.

Question 18: **(Dec 21)**

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?

Answer:

Other Written Representation:

1) 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.
2) The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them.
3) 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:

a) Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
b) The terms of the audit engagement were prepared in a previous year;
c) There is any indication that management misunderstands those responsibilities; or
d) Changes in circumstances make it appropriate to do so.



CHAPTER 8

AUDIT REPORT

Case Study

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients. You are requested to go through the following and answer the questions that follow:

- During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statements and if auditor persists they may give the effect in the next financial year.
- During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr B.
- During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.

Based upon above, answer the following questions:

1) In case of M/s Persistent & Company, what would be an ideal Audit Opinion?
   a) Unmodified
   b) Qualified
   c) Mention the fact in Emphasis of Matter Paragraph
   d) Disclaimer

2) In case of M/s Dubious Brothers, what Audit Opinion should the Auditor give?
   a) Qualified
   b) Adverse
   c) Disclaimer
   d) Unmodified

3) According to you, what would be appropriate course to take in case of M/s Honest & Associates?
   a) Issue Qualified Opinion
   b) Issue Adverse Opinion
   c) Mention the fact of change in method in Emphasis of Matter Paragraph
   d) Issue Disclaimer of Opinion

4) When the Auditor, after conclusion of an Audit exercise, is of the opinion that there are material misstatements in the Financial Statements, but they are not pervasive, then what should an Auditor do?
   a) Issue Unmodified Opinion
   b) Issue Qualified Opinion
   c) Issue Disclaimer of Opinion
   d) Mention it in Emphasis of Matter Paragraph

5) When the Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, Auditor shall give:
   a) Modified Opinion
   b) Qualified Opinion
   c) Disclaimer of Opinion
   d) Unmodified Opinion

Answers to Case Study:

1) b)
2) c)
3) c)
4) b)
5) d)

Independent MCQ's

1) While expressing an unmodified opinion on financial statements, the auditor shall not use which of the following phrases?
   a) present fairly in all material respects
   b) give a true and fair view
   c) with the foregoing explanation
   d) All of the above

2) ..... is 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 judgement, is of such importance that it is fundamental to the user's understanding of the financial statements.
   a) Emphasis of Matter Paragraph
   b) Other Matter Paragraph
   c) Key Audit Matter
   d) Management Responsibility Paragraph.

3) Statement 1: Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements. Statement 2: Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.
   a) Only Statement 1 is correct
   b) Only Statement 2 is correct
   c) Both the statements are correct
   d) None of the statement is correct

4) Which of the following is not correct?
   a) SA 700 - Forming an Opinion and Reporting on the Financial Statements
   b) SA 701- Key Audit Matters in the Independent Auditor's Report
   c) SA 705- Comparative Information- Corresponding figures and Comparative Financial Statements
   d) SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

5) Responsibilities of Joint Auditors are governed by:
   a) SA 200
   b) SA 229
   c) SA 299
   d) SA 230

Answers to the MCQs based Questions:

1) c)
2) a)
3) d)
4) c)
5) c)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **The auditor shall express a qualified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.**

Ans: Incorrect: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

2) **There is no need of addressee in the Auditor's report.**

Ans: Incorrect: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

3) **The auditor shall modify the opinion in the auditor's report only when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.**

Ans: Incorrect: The auditor shall modify the opinion in the auditor's report when:

a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

4) **The auditor shall express a disclaimer of 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.**

Ans: Correct: 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.

5) **Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.**

Ans: Correct: 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 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.

6) **When the auditor has to express an adverse opinion, he need not communicate with those charged with governance as this may have an impact on payment of his audit fees.**

Ans: Correct: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

7) **Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.**

Ans: Correct: 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).

8) The concept of "joint audit" has legal foothold under the Companies Act, 2013.

Ans: Correct: Under provisions of section 139(3), the members of a company may resolve to provide that audit shall be conducted by more than one auditor. Hence, the concept of "joint audit" has legal foothold also under Companies Act, 2013.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?

Answer:

The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number.

Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs. It is required to be stated in case of audit reports and certificates.

Question 2: **(ICAI SM)**

CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.

Answer:

"Basis for Opinion" is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion. **Therefore, Sana's thinking is not proper.**

Question 3: **(ICAI SM)**

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality. He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements. Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

Answer:

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.

In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

Question 4: **(ICAI SM)**

CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.

Answer:

As per **SA 600 - "Using the Work of Another Auditor"**, 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.

Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. **It is not an encroachment of another auditor's domain.**

Question 5: (ICAI SM)

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements. Is there any reporting obligation upon him under CARO, 2020?

Answer:

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

Question 6: (ICAI SM)

"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." Explain

Answer:

1) 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.
2) 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.
3) 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

Question 7: **(ICAI SM)**

"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 judgements." Discuss stating clearly qualitative aspects of the entity's accounting practices

Answer:

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.

Qualitative Aspects of the Entity's Accounting Practices

1) Management makes a number of judgements 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 judgements. The auditor may conclude that the cumulative effect of lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality include the following:
   a) The selective correction of misstatements brought to management's attention during the audit.
   b) Possible management bias in the making of accounting estimates.
4) **SA 540** addresses possible management bias in making accounting estimates.

Question 8: **(ICAI SM)**

Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.

Answer:

The decision regarding which type of modified opinion is appropriate depends upon:

a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements

Question 9: **(ICAI SM)**

Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".

Answer:

As per **SA 705 "Modifications To The Opinion In The Independent Auditor's Report"**, the objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Question 10: **(ICAI SM)**

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.

Answer:

1) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements.

2) 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:

   a) The selective correction of misstatements brought to management's attention during the audit.

   b) Example

      (i) Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

      (ii) 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 judgement and involvement of audit executives.

   c) Possible management bias in the making of accounting estimates.

Question 11: **(ICAI SM)**

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.

Answer:

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:

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.

Question 12: **(ICAI SM)**

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Answer:

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 judgement, 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:

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.

Question 13: **(ICAI SM)**

"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

Answer:

Specific Evaluations by the auditor:

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.

Question 14: **(ICAI SM)**

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

Answer:

Responsibilities for the Financial Statements:

1) The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."
2) 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.
3) 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.
4) 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.

5) 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.

Question 15: **(ICAI SM)**

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.

Answer:

Communicating key audit matters in the auditor's report is not:

a) 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) 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) 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
d) A separate opinion on individual matters

Question 16: **(ICAI SM)**

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.

Answer:

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.

Question 17: **(ICAI SM)**

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

Answer:

1) An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.
2) Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.
3) **SA 705 - "Modifications To The Opinion In The Independent Auditor's Report"** deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.
   a) **Adverse Opinion**

   We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2021, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements").

   In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial

statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2021, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

b) Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2021, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)) .

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 give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2021 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Question 18: **(ICAI SM)**

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.

Answer:

1) 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.
2) 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:

3) 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.
4) 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.

Question 19: **(ICAI SM)**

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.

Answer:

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 in directing the engagement team's efforts;
d) consider the results of preliminary engagement activities, or similar engagements performed earlier.
e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

Question 20: **(ICAI SM)**

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.

Answer:

Joint Audit:

1) The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations.
2) 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.

3) 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:
   a) Sharing of expertise.
   b) Advantage of mutual consultation.
   c) Lower workload.
   d) Better quality of performance.
   e) Improved service to the client.
   f) 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.
   g) Lower staff development costs.
   h) Lower costs to carry out the work.
   i) A sense of healthy competition towards a better performance

Question 21: **(ICAI SM) / (Dec 21)**

Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

Answer:

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year 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;

b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance;

Question 22: **(ICAI SM)**

Discuss which class of companies are specifically exempt from the applicability of CARO 2020?

Answer:

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

a) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
b) an insurance company as defined under the Insurance Act,1938 (4 of 1938);
c) a company licensed to operate under section 8 of the Companies Act;
d) a One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and
e) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

Questions from PAST Exam / RTP / MTP (As per OLD Syllabus)

Question 23: **(Dec 21)**

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?

Answer:

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.

Question 24: **(July 21) / (RTP May 22)**

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)?

Answer:

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)

Question 25: **(Jan 21)**

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?

Answer:

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:

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.

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):

a) 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
b) Within this section, include a description of the matter giving rise to the modification.

Question 26: **(Nov 20)**

How would an auditor determine Key Audit Matters as per SA - 701, "Communicating Key Audit Matters in the Independent Auditor's Report"?

Answer:

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.

Question 27: **(RTP May 22)**

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.

Answer:

1) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
2) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.
3) 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.
4) 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.
5) The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

Question 28: **(RTP Nov 21)**

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020 - 21 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

Explain the kind of audit report that the statutory auditor of the company should issue in this case.

Answer:

1) The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
2) The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.
3) In the present case Delightful Ltd, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. Moreover, the auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.
4) As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

Question 29: **(RTP May 21)**

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.

Answer:

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:
   a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
   b) the financial statements comply with relevant statutory requirements and regulations; and
   c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Question 30: **(RTP May 21)**

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain.

Answer:

1) 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.
2) This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.
3) 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.
4) It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Question 31: **(RTP Nov 20)**

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Answer:

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:

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.

Question 32: **(RTP Nov 20)**

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.

Answer:

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.

Question 33: **(MTP Mar 22)**

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."

Answer:

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 report if the company has defaulted in repayment of such loans raised;

Question 34: **(MTP Mar 22)**

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?

Answer:

1) As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if, 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 shall request that management remove the limitation.
2) 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.
3) If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
   a) 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
   b) 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.
4) 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.

Question 35: **(MTP Mar 22)**

State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits.

Answer:

Matters to be included in Auditor's report as per CARO 2020:

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;

Question 36: **(MTP Nov 21)**

Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

Answer:

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.

CHAPTER 9

SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

Case Study

Consider the following five descriptions: -

A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India. Following is extract of few audit findings placed on website cag.gov.in. "The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view. Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."

B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: - "The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants."

C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.

D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.

E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India. The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

Based upon above, answer the following questions:

1) Based upon plain reading of audit findings stated at Para (A), identify type of audit carried out by office of the Comptroller and Auditor General of India.
   a) Audit against provision of funds
   b) Propriety audit
   c) Performance audit
   d) Compliance audit

2) Keeping in view audit findings in respect of Haryana Power Generation Corporation Limited, identify type of audit carried out.
   a) Audit of Government Company
   b) Audit against rules and orders
   c) Compliance audit
   d) Performance audit

3) Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?
   a) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.
   b) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.
   c) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.
   d) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.

4) Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?
   a) Central Government
   b) Another independent auditor appointed by CAG
   c) CAG
   d) Another independent auditor appointed by Ministry of Corporate Affairs

5) As regards comments of auditors specified in respect of audit report of above insurance company, which of the following is likely to be most appropriate statement?
   a) Such are likely to be comments of test audit carried out by CAG.
   b) Such are likely to be comments in respect of directions to statutory auditor by CAG for reporting on specific aspect of their audit work.
   c) Such are likely to be comments of supplementary audit carried out by CAG
   d) Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing

Answers to Case Study

1) c)
2) d)
3) a)
4) c)
5) b)

Independent MCQ's

1) The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?
   a) To report on the adherence to legal and administrative requirements
   b) To report on whether value is being fully received for money spent
   c) To report on the weakness of systems of financial control
   d) To provide better civic amenities to residents of metro city

2) "Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?
   a) Income Tax Act, 1961
   b) Foreign Contribution Regulation Act, 2010
   c) Companies Act, 2013
   d) Orders issued by Ministry of Social Justice and Empowerment

3) The appointment of first auditor of a multi-state cooperative society is made by: -
   a) Central Registrar
   b) Board of society
   c) Members of society
   d) Central Government

4) Consider following revenue sources of Union Government.
   (P) Revenues from direct taxes
   (Q) Revenues from Goods and Services Tax
   (R) Revenues from Custom Duties
   (S) Revenues from Excise Duties

Out of P, Q, R and S, which of the following flow to "Consolidated Fund of India"?

a) P, Q and R
b) P, Q and S
c) P and Q
d) P, Q, R and S

5) An LLP files compliance returns with: -
a) Registrar of firms & societies
b) Central Registrar
c) Registrar of Companies
d) Local fund audit wing

Answers to the MCQs based Questions:

1) d)
2) b)
3) b)
4) b)
5) c)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the finance minister may on the advice of the C&AG prescribe.**

Ans: **Incorrect:** Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

2) **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.**

Ans: **Correct:** 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 i.e. the expenditure is incurred with due regard to broad and general principles of financial propriety.

3) **Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments**

Ans: Correct: Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments, etc., mostly related to civic amenities and local area development and maintenance.

4) **The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.**

Ans: Incorrect: 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.

5) **NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.**

Ans: Correct: NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations. These would include religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc. The scope of services rendered by NGOs is extremely wide.

6) **The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009.**

Ans: Incorrect: Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rules.

7) **The auditor of an LLP may be appointed by the Designated Partners or other Partners whosoever is available at the time of appointment.**

Ans: Incorrect: The auditor is to be appointed by the designated partners of the LLP. However, the Partners may appoint the auditors only if the Designated Partners have failed to appoint them.

8) **The Comptroller and Auditor General does not have any authority to audit the accounts of stores and inventory kept in any office or department of the Union or of a State.**

Ans: Incorrect: 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. 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.

9) **An Operating Lease is a kind of Financing arrangement.**

Ans: Incorrect: A Finance Lease is a Financing arrangement. An Operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

10) **An auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts in the case of audit of a Hotel.**

Ans: Correct: The auditor should ensure that proper valuation of occupancy-inprogress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintenance of accounts on Accrual basis as per the Matching concept.

11) **The first auditor of a Multi-State co-operative Society will be appointed in Annual General Meeting.**

Ans: Incorrect: Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State Co-operative Society in the general meeting may appoint the first auditor or auditors.

12) Small LLPs are mandatorily required to get their Books of account audited.

Ans: Incorrect: The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009, which provide that any LLP whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty-five lakh rupees, is not required to get its accounts audited.

a) Further, a Small LLP is any LLP the Contribution of which, does not exceed twenty-five lakh rupees (INR 25,00,000) or such higher amount, not exceeding five crore rupees, as may be prescribed; and

b) the Turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees (INR 40,00,000) or such higher amount, not exceeding fifty crore rupees, as may be prescribed;

Hence, the provisions of audit are not applicable on Small LLP's. Therefore, the Small LLPs can prepare its financial statement merely with the signatures of the Designated Partners.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

It is the duty of Comptroller and Auditor General of India 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. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance?

Answer:

1) Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India.
2) Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

Question 2: **(ICAI SM)**

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

Answer:

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

Question 3: **(ICAI SM)**

You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?

Answer:

The fees concessions have to be under proper authority of school management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

Question 4: **(ICAI SM)**

A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary. Identify type of society and also discuss nature of books of accounts to be maintained by such a society.

Answer:

1) The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state.
2) It accepts small savings from its members and grants loan to members. As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to:
   a) all sum of money received and expended and matters in respect of which the receipt and expenditure take place
   b) the assets and liabilities

Question 5: **(ICAI SM)**

Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society.

Answer:

The Central Registrar may, on a request from:

a) a federal co-operative to which a Multi- State Co-operative society is affiliated or
b) a creditor or not less than one-third of the members of the board or
c) not less than one-fifth of the total number of members of a Multi-state co-operative society,

Question 6: **(ICAI SM)**

Sporting Club of India is a private club engaged in promotion of sports in the country. As an auditor of this leading club, discuss any two points to ensure that expenditure incurred by club during the year is properly authorised.

Answer:

The special steps involved in such an audit are stated below:

1) **Entrance Fee:** 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) **Subscriptions:** 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.

Question 7: **(ICAI SM) / (July 21)**

Tomo Construction Engineering LLP approached CA K to understand various returns to be filed by them as part of statutory compliance. Discuss, how, CA K should advise them.

Answer:

Returns to be maintained and filed by an LLP:

1) 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.
2) 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 the financial year to which the Statement of Account and Solvency relates.

Question 8: **(ICAI SM)**

A muti-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital.

Answer:

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 with 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.

Question 9: **(ICAI SM)**

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?

Answer:

While planning the audit, the auditor may concentrate on the following:

1) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
2) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
3) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
4) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
5) 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.

6) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
7) Setting of materiality levels for audit purposes.
8) The nature and timing of reports or other communications.
9) The involvement of experts and their reports.
10) Review the previous year's Audit Report.

Question 10: **(ICAI SM)**

Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only INR 500 per month from a student for their lodging/boarding.

Answer:

1) Examining the rent roll and inspecting tenancy agreements, noting in each case:
   a) the amounts of the rent, and
   b) the due dates.
2) Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

Question 11: **(ICAI SM)**

Explain in detail the duties of Comptroller and Auditor General of India

Answer:

1) **Compilation and Submission of Accounts:**
   He shall compile the accounts of the Union/State/Union Territory and submit those accounts to the President / Governor / Administrator respectively.
2) **Audit of Receipts and Expenditure:**
   He shall audit and report on all receipts and expenditure of any body, which has been substantially financed from the Consolidated Fund of India/State/Union Territory.
3) **Audit of Grants or Loans:**
   a) 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 hto any authority or body, not being a foreign State or international organization.
   b) The Comptroller and Auditor General shall scrutinize 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.

4) **Audit of receipts of Union or States:**
The CAG shall review rules and procedures designed to secure an effective check on assessment, collection and proper allocation of revenue, for all receipts payable into Consolidated fund of India/Sate/Union Territory.

5) **Audit of Accounts of Stores and Inventory:**
The CAG shall have the authority to audit and report on the accounts of stores and inventory kept in any office or department of the union or state.

6) **Audit of Government Companies & Corporations:**
CAG shall exercise powers and observe duties as per the provisions of the Companies Act, 2013 in relation to the Government Companies or Corporations.

7) General provisions relating to Audit It shall be the duty of the Comptroller and Auditor General –
   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 relating to Contingency Funds and Public Accounts;
   c) To audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

Question 12 (ICAI SM)

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 six 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.

Answer:

Receipt of Donations:

a) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

b) **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.

c) **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.

d) **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.

e) **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.

f) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

a) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

b) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.

c) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

d) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.

e) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

f) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

Question 13: **(ICAI SM)**

As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.

Answer:

1) The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.

2) The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
3) Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.
4) In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room.
5) This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.
6) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts. The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

Question 14: **(ICAI SM) / (Jul 21) / (RTP May 21)**

Define Government Audit & explain its objectives.

Answer:

Definition of Government Audit:

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.

Question 15: **(ICAI SM) / (Dec 21)**

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.

Answer:

1) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.
2) 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.

Question 16: **(ICAI SM) / (Dec 21)**

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.

Answer:

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:

a) to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
b) to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
c) to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
d) 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.
e) 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.

Question 17: **(ICAI SM)**

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?

Answer:

The auditor while auditing the local bodies should report on the

a) fairness of the contents and presentation of financial statements,
b) the strengths and weaknesses of system of financial control,
c) the adherence to legal and/or administrative requirements;
d) whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.

Question 18: **(ICAI SM) / (July 21)**

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.

Answer:

Points which merit your consideration as an auditor while verifying Assets and 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 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, foodstuffs, 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.

Questions from PAST Exam/ RTP / MTP (As per OLD Syllabus)

Question 19 (ICAI SM) / (MTP Mar 22) / (MTP Oct 21) / (Jul 21)

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.

Answer:

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 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:** 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.

Question 20: **(Jan 21)**

As an Auditor of NGO, how do you check/verify atleast four receipts of income during the year?

Answer:

The receipt of income of NGO may be checked on the following lines:

1) **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.
2) **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.
3) **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.
4) **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.
5) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Question 21: **(Jan 21)**

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.

Answer:

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 have been 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.

Question 22: **(Nov 20)**

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.

Answer:

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.

Question 23: **(Nov 20)**

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.

Answer:

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;

a) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;
b) 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;
c) whether such regulations and procedures are actually being carried out;
d) 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
e) 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.
f) 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.
g) 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.

h) 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.

Question 24: **(Nov 20)**

Explain the different types of revenue grants which local bodies may receive.

Answer:

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.

Question 25: **(Nov 20) / (MTP Nov 21)**

What is the function of audit while examining various rules, regulations and orders with regard to Audit against Rules & Orders by C&AG?

Answer:

Audit against Rules & Orders:

1) 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.

2) It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities.

3) The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities.

4) 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.

Question 26: **(RTP May 22)**

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.

Answer:

Inspection of Multi-State Co-operative societies under Section 79

1) **When:** The Central Registrar may, on a request from
   a) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or
   b) not less than one-third of the members of the board or
   c) 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.

Question 27: **(MTP Apr 22) / (RTP Nov 20)**

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

Answer:

Audit against Rules & Orders:

1) 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.
2) 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:
   a) 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);
   b) 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
   c) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.
3) 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.
4) 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.

5) 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.

Question 28: **(RTP Nov 20)**

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

Answer:

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.

Question 29: **(MTP Nov 21)**

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.

Answer:

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:

a) 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.

b) 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.

c) 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.

d) 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.

Notes:

CHAPTER 10

AUDIT OF BANKS

Case Study

CA M is conducting statutory audit of branch of MMC Bank. During the course of audit, it is noticed as under:-

(i) Loans under "Kisan credit card" are given by Bank to farmers to meet their short-term credit needs for cultivation of crops. In respect of one agricultural advance classified under "Kisan Credit Card" having an outstanding balance of ` 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as "Standard asset".

(ii) It is also observed that account of one borrower availing cash credit limit of `50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in "Manual of Delegation of Powers" of Bank.

(iii) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of `1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.

(iv) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.

(v) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance sheet.

Based upon above, answer the following questions:

1) As regards description of agricultural advance, which of the following statements is most appropriate in this regard?
   - **a)** The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset.
   - **b)** The classification made by branch is proper. However, there are no transactions in account since last 90 days, it is SMA.
   - **c)** The classification made by branch is proper.
   - **d)** The branch has erred in making classification as per RBI norms. It is a "doubtful" asset.

2) Regarding taken over account from another bank, which of following statements is most appropriate?
   a) It is an internal issue of Bank and auditor is not concerned with it.
   b) It is an internal issue of Bank. However, the auditor may, at his discretion, report it.
   c) It is a serious violation of laid down procedures of bank for sanction of advances and should be reported by auditor without fail.
   d) There is no issue involved as credit facility was properly sanctioned.

3) As regards debit balance of ` 1.50 lacs in Savings account, which of the following is correct from point of view of an auditor?
   a) The situation does not attract RBI norms on asset classification.
   b) The debit balance of `1.50 lacs should be classified as NPA.
   c) The situation does not attract RBI norms on asset classification as no credit facility was granted.
   d) The bank cannot demand excess interest paid to account holder.

4) Which of the following statements is not true about "drawing power" (DP)?
   a) Drawing Power refers to the amount calculated based on primary security less margin as on particular date.
   b) It is always less than sanctioned limit.
   c) It can be different from sanctioned limit.
   d) Creditors for goods are reduced for purpose of calculating Drawing Power.

5) Considering housing loan and car loan availed by a borrower, which of the following statements is appropriate?
   a) Both Housing loan as well as car loan should be classified as "NonPerforming Assets" in accordance with RBI norms on asset classification.
   b) Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.
   c) Car Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.
   d) Both Housing as well as car loans should be classified as Standard assets.

Answers to Case Study:

1) c)
2) c)
3) b)
4) b)
5) a)

Independent MCQ's

1) Which of the following is included in "Interest Earned" in Profit & loss A/c of a bank?
   a) Discount on Bills
   b) Loan Processing fees
   c) Commission on bills for collection
   d) Credit Card Fees

2) While auditing advances of a bank as statutory auditor, which of the following is not a likely concern of auditor?
   a) Appropriate documentation of advances
   b) Ensuring budgeted targets of advances given by bank management
   c) Compliance of sanctioned terms and conditions
   d) Operations in advance accounts

3) Any amount due to the bank under any credit facility is 'overdue' if: -
   a) it is not paid on the due date fixed by the bank
   b) it is not paid within 30 days of due date fixed by the bank
   c) it is not paid within 60 days of due date fixed by the bank
   d) it is not paid within 90 days of due date fixed by the bank

4) Which of the following statement is true regarding appointment of statutory branch auditor of a nationalized bank?
   a) The appointment is made by bank acting through its board of directors with prior approval of Central govt.
   b) The appointment is made by bank acting through its board of directors with prior approval of RBI
   c) The appointment is made by bank acting through its board of directors with prior approval of ICAI
   d) The appointment is made by shareholders in AGM.

5) Identify the correct statement: -
   a) Income from non-performing assets is recognized on accrual basis
   b) Income from non-performing assets is never recognized.
   c) Income from non-performing assets is recognized on basis of actual recovery
   d) Income from non-performing assets is recognized only when such assets are upgraded to standard assets

Answers to the MCQs based Questions:

1) a)
2) b)
3) a)
4) b)
5) c)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.**

Ans: Incorrect: RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks. All the Banks and even NBFC's fall under the regulatory function of RBI.

2) **In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines.**

Ans: Incorrect: In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

3) **The auditor can assume that the system generated information is correct and relied upon.**

Ans: Incorrect: The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.

4) Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.

Ans: Incorrect: 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. Collateral security is in addition to the Primary security.

5) Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof

Ans: Incorrect: 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.

6) Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.

Ans: Incorrect: Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank and 90 days of becoming overdue.

7) An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Ans: Correct: 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.

8) Banks recognize income on Non-Performing Assets on accrual basis.

Ans: Incorrect: Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received i.e. on actual receipt basis.

9) Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.

Ans: Incorrect: Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

10) **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 in case of audit of ABA Bank Ltd.**

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. The Banking Company is bound to disclose remedial action taken in Board's report.

11) **Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets.**

Ans: Correct: Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

Answer:

1) Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks.
2) Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.
3) Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Question 2: **(ICAI SM)**

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of `100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ` 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

Answer:

Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business. Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

Question 3: **(ICAI SM)**

During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

Answer:

1) Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.
2) In the given case, ten term loan accounts have been classified as SMA. It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.
3) Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

Question 4: **(ICAI SM)**

CA P is conducting stock audit of a borrower availing cash credit facility of `100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

Value of stocks	` 125 lacs

Value of stocks (fully damaged) included in above	5 lacs
Value of debtors	50 lacs
Value of debtors exceeding 90 days included in above	10 lacs
Value of creditors for goods	50 lacs

Is Drawing Power computed by CA P for ` 82.50 lacs proper?

Answer:

The computation of Drawing power is as under: -

Particulars	In Rs
Value of stocks as on 31.12.22	` 125 lacs
Less: value of damaged stocks	` 5 lacs
	` 120 lacs
Less: creditors for goods as on 31.12.22	` 50 lacs
Value of Paid stocks	` 70.00 lacs
Less: Margin @ 25%	`17.50 lacs
Drawing power (A)	` 52.50 lacs
Value of debtors as on 31.12.22	` 50 lacs
Less: debtors exceeding 90 days	` 10 lacs
	`40 lacs
Less: Margin @ 40%	` 16 lacs
Drawing Power (B)	` 24 lacs
Drawing Power (A+B)	` 76.50 lacs

Conclusion:

The drawing power calculated by CA P is not proper. Drawing Power comes to ` 76.50 lacs.

Question 5: **(ICAI SM)**

You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch.

Answer:

1) The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate.

2) The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
3) The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

Question 6: **(ICAI SM)**

Discuss outline of audit approach including audit procedures while auditing "provisions and contingencies" in financial statements of a bank.

Answer:

The auditor should:

1) Ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
2) 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.
3) Obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
4) 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.
5) Examine the other provisions for expenses 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.

Question 7: **(ICAI SM)**

Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.

Answer:

Assess the Risk of Fraud including Money Laundering:

1) 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.

2) The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.
3) The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms.
4) 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.

Question 8: **(ICAI SM)**

List out any four points which highlight peculiarities involved in banking operations.

Answer:

1) Huge volumes and complexity of transactions;
2) Wide geographical spread of banks' network;
3) Large range of products and services offered;
4) Extensive use of technology;
5) Strict vigilance by the banking regulator etc.

Question 9: **(ICAI SM)**

Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor's Report) Order, 2020?

Answer:

1) It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report the matters covered by Section 143 of the Companies Act, 2013.
2) However, it is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2020 is not applicable to a banking company, as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949.

Question 10: **(ICAI SM)**

Account of a borrower availing cash credit facility from branch of a bank has become "Out or order." Discuss the term "Out of order".

Answer:

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

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

2) 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
3) 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'.

Question 11: **(ICAI SM)**

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain

Answer:

1) The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.
2) RBI is responsible for:
   a) development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions)
   b) determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
   c) regulating the activities of commercial and other banks
3) Important functions of RBI are:
   a) issuance of currency;
   b) regulation of currency issue;
   c) acting as banker to the central and state governments; and
   d) acting as banker to commercial and other types of banks including termlending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks.
4) No bank can commence the business of banking or open new branches without obtaining license from RBI. The RBI also has the power to inspect any bank.

Question 12: **(ICAI SM)**

"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". Explain

Answer:

1) All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the "Engagement Team".

2) 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.
3) All these discussions should be appropriately documented for future reference. The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's branch financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.
4) The engagement team discussion ordinarily includes a discussion of the following matters:
   a) Errors that may be more likely to occur;
   b) Errors which have been identified in prior years;
   c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
   d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
   e) Need to maintain professional skepticism throughout the audit engagement;
   f) 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).

Question 13: **(ICAI SM)**

Write a short note on reversal of income under bank audit.

Answer:

1) 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.
2) 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.
3) 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).
4) 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.

Questions from PAST Exam / RTP / MTP (As per OLD Syllabus)

Question 14: **(Dec 21)**

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

Answer:

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.

Question 15: **(July 21)**

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.

Answer:

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

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

b) 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

c) 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

Question 16: **(July 21)**

Discuss the advantages of engagement team discussion done at the planning stage of the bank audit.

Answer:

Advantages of engagement team discussion done at the planning stage of Bank audit are:

1) 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.

2) 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.

3) Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

Question 17: **(Jan 21)**

Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

Answer:

1) 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.
2) 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.
3) 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.

Question 18: **(Nov 20)**

You are appointed as Statutory Auditor of DEF Bank Limited for the year 2019-20. As an Auditor how will you verify Provisions created by DEF Bank Limited?

Answer:

1) For audit of Provisions, 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.
2) 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.
3) 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.
4) The other provisions for expenses should be examined vis-à-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Question 19: **(RTP May 22) / (MTP Oct 21)**

There are different provisioning requirements as regards to categories of NPA such as Sub-standards assets, Doubtful assets and loss assets. Explain in detail.

Answer:

1) 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.
2) Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.
3) 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**
(i) **Substandard Assets:** 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) Doubtful	40% + 100%
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%

Question 20: **(RTP May 22)**

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.

Answer:

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.

Question 21: **(RTP Nov 21)**

The engagement team discussion ordinarily includes a discussion of the matters such as - 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; etc.

In the above context, explain the advantages of such a discussion.

Answer:

Advantages of such a discussion:

1) 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.

2) 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.
3) Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

Question 22: **(RTP Nov 21)**

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense.

Answer:

1) In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.
2) The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate.
3) The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
4) The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.
5) The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger.

6) The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.
7) The auditor should, on a test check basis, verify the calculation of interest and ensure that:
   a) Interest has been provided on all deposits upto the date of the balance sheet;
   b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;
   c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.
   d) Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.
8) The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly.
9) The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers.
10) The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

Question 23: **(RTP May 21)**

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.

Answer:

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

1) 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.

2) Long Form Audit Report. (LFAR)
3) Report on compliance with SLR requirements.
4) 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.
5) 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.
6) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
7) 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.
8) Report on instances of adverse credit-deposit ratio in the rural areas.

Question 24: **(RTP May 21)**

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.

Answer:

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.

Question 25: **(RTP Nov 20)**

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.

Answer:

1) **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.
2) **Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.
3) Examples of most common types of securities accepted by banks are the following:
   a) Personal Security of Guarantor
   b) Goods/Stocks/Debtors/Trade Receivables
   c) Gold Ornaments and Bullion
   d) Immovable Property
   e) Plantations (For Agricultural Advances)
   f) Third Party Guarantees
   g) Banker's General Lien
   h) Life Insurance Policies
   i) Stock Exchange Securities and Other Instruments

Question 26: **(RTP Nov 20)**

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.

Answer:

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.

1) **Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

a) **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.

b) **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.

2) **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.

3) **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.

4) **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.

5) **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.

6) **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.

Question 27: **(MTP Mar 22)**

Explain the categories of Agricultural Advances in case of Banks and related NPA norms.

Answer:

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.
3) 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.
4) 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.
5) The following NPA norms would apply to agricultural advances (including Crop Term Loans):
   a) 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
   b) 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.

Question 28: **(MTP Apr 22)**

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

Answer:

Audit Approach and Procedures

1) **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.

2) **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.
3) **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.
4) **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.
5) **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.

Question 29: **(MTP Mar 21)**

There are different types of banks prevailing in India. Explain giving examples of such banks.

Answer:

There are different types of banking institutions prevailing in India which are as follows:

1) **Commercial banks** are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:
   a) accepting deposits and
   b) granting advances.
2) **Regional Rural Banks** known as **RRBs** are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. **Examples are** :- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3) **Co-operative Banks** function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. **Examples are**: The Gujarat State Co-operative Bank Ltd., Chhatisgarh Rajya Sahakari Bank Maryadit, etc.
4) **Payments Banks** are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards, Internet-banking & Mobilebanking. **Examples are:** Airtel Payments Bank, India Post Payments Bank, Paytm Payments Bank, etc.
5) **Development Banks** had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. **Examples are:** Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), etc.
6) **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc. **Examples are:** Equitas Small Finance Bank, AU Small Finance Bank, etc.

Question 30: **(MTP Nov 21)**

Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

Answer:

1) 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.
2) 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.
3) 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.

CHAPTER 11

ETHICS AND TERMS OF AUDIT ENGAGEMENTS

Case Study

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together. However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of "weather-forecasting". Such services would be available on web site of company and micro weather information would be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm choses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements.

The company also offers auditors contract for providing IT services pertaining to information system of company.

Based upon above, answer the following questions:

1) Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?
   a) The above discussion is irrelevant in context of proposed offer.
   b) The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.
   c) The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.
   d) The matter is too trivial to be reported by CA Sukanya to other partners of firm.

2) Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.
   a) Self-interest threat

b) Familiarity threat
c) Self-review threat
d) Advocacy threat

3) The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principle of professional ethics is not followed by them?
a) Objectivity
b) Professional behaviour
c) Professional competence and due care
d) Integrity

4) Das & Co. have failed to advise the company regarding audit of consolidated financial statements. Which fundamental principle of professional ethics is violated by Das & Co.?
a) Professional behaviour
b) Integrity
c) Objectivity
d) Professional competence and due care

5) Which of the following statements is most appropriate regarding providing offer of work of IT services by auditors to the company?
a) Such offer may create a self-review threat.
b) Such offer may create an advocacy threat.
c) Such offer does not constitute any threat.
d) Such offer may create self-review and advocacy threats.

Answers to Case Study:

1) c)
2) d)
3) b)
4) d)
5) a)

Independent MCQ's

1) Identify the most appropriate statement:
   a) SA 220 applies at the level of firm.
   b) SQC 1 is premised on the basis that firm is subject to SA 220.
   c) SA 220 is premised on the basis that firm is subject to SQC 1.
   d) SA 220 applies to all engagements.

2) Professional skepticism includes-
   a) Overlooking unusual circumstances.
   b) Using inappropriate assumptions in determining extent of audit procedures.
   c) Over generalising when drawing conclusions from audit observations.
   d) Being vigilant to conditions that might indicate possibilities of fraud.

3) Which of the following is not a fundamental principle governing professional ethics?
   a) Professional competence and due care
   b) Integrity
   c) Objectivity
   d) Safeguards to independence

4) Which of the following is not necessary to establish preconditions for an audit?
   a) Acceptability of financial reporting framework.
   b) Acknowledgment of cooperation from management in designing audit procedures.
   c) Acknowledgment from management of providing access to persons within company.
   d) Acknowledgment of management in understanding its responsibility for preparation of financial statements.

5) Identify the most appropriate statement in context of SQC 1.
   a) Assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements.
   b) Engagement files should be completed before date of auditor's report in case of audit engagements.
   c) Engagement files should be completed in not more than 60 days after completion of an engagement.
   d) Engagement files should be completed on date on which audit report is signed in case of audit engagements.

Answers to the MCQs based Questions:

1) c)
2) d)
3) d)
4) b)
5) a)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) **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.

2) **The Audit Engagement documentations should ordinarily be retained by the auditor for minimum of six years from the date of the auditor's report or the date of the group auditor's report, whichever is later.**

Ans: Incorrect: 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.

Descriptive Questions

Questions from ICAI Study Material

Question 1: **(ICAI SM)**

CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

Answer:

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.

Question 2: **(ICAI SM)**

A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for ₹ 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was ₹ 15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

Answer:

"Integrity" requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. **Therefore, fundamental principle of "integrity" is violated.**

Question 3: **(ICAI SM)**

CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

Answer:

1) When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.
2) Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment.
3) Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

Question 4: **(ICAI SM)**

A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

Answer:

Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

Question 5: **(ICAI SM)**

CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

Answer:

In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "self-review" threat.

Question 6: **(ICAI SM)**

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

Answer:

In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors.

Question 7: **(ICAI SM)**

Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report beforehand. Try to help Chirag by making things clear to him.

Answer:

Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

Question 8: **(ICAI SM)**

The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

Answer:

1) It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210.
2) If the preconditions for an audit are not present, the auditor shall discuss the matter with management.
3) Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -
   a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
   b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.
4) Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary as management is not willing to accept its responsibility for preparation of financial statements in accordance with applicable financial reporting framework.
5) An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

Question 9: **(ICAI SM)**

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

Answer:

1) Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1.
2) SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.
3) In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

Question 10: **(ICAI SM)**

CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging "fin-tech" sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

Answer:

1) SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.
2) In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging "fintech" sector.
3) The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted.

Question 11: **(ICAI SM)**

Briefly outline how principles-based approach differs from rules-based approach to ethics.

Answer:

1) Ethical guidance may follow principles-based approach or rules-based approach.
2) The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise.
3) It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.
4) However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules.
5) Further, rules- based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules. Therefore, it is necessary that spirit of code is followed.

Question 12: **(ICAI SM)**

How application of professional skepticism throughout audit is helpful in reducing audit risk?

Answer:

1) 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.
2) It signifies that auditor has to remain alert forever. The auditor's attitude should be of questioning mind- of challenging the things in light of available 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.
3) Professional skepticism includes being alert to, for example:
   a) Audit evidence that contradicts other audit evidence obtained.
   b) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
   c) Conditions that may indicate possible fraud.
   d) Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
4) 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.
d) Professional skepticism is necessary to the critical assessment of audit evidence.

5) It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.
6) The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary.
7) Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.
8) The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

Question 13: **(ICAI SM) / (RTP May 21)**

A Chartered accountant is conducting audit of a client for last two years. Before proceeding to start audit for next year, he notices that there is substantial change in management. Besides, client has ventured into areas of business activity which were not present at time of accepting initial audit engagement. Discuss responsibility of auditor in this regard in context of SA 210.

Answer:

1) Recurring audit is an audit which is performed by an auditor over years. 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.
2) The auditor may decide not to send a new audit engagement letter or other written agreement each period.
3) However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
   a) Any indication that the entity misunderstands the objective and scope of the audit.
   b) Any revised or special terms of the audit engagement.

c) A recent change of senior management.
d) A significant change in ownership.
e) A significant change in nature or size of the entity's business.
f) A change in legal or regulatory requirements.
g) A change in the financial reporting framework adopted in the preparation of the financial statements.
h) A change in other reporting requirements.

Question 14: **(ICAI SM)**

How does SQC 1 ensure that independence in engagements is not breached by an audit firm?

Answer:

1) The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements contained in the Code of ethics issued by ICAI.
2) The Code establishes the fundamental principles of professional ethics which include
   a) integrity,
   b) objectivity,
   c) professional competence and due care,
   d) confidentiality and
   e) professional behaviour.
3) Observance of "Independence" in all engagements is the basic requirement.
4) The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence where required by the Code. Such policies and procedures should enable the firm to: -
   a) Communicate its independence requirements to its personnel
   b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.
5) There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence.
6) All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied. At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

Question 15: **(ICAI SM)**

An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?

Answer:

1) Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement.
2) 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.
   b) The fact that quality is essential in performing audit engagements.

Questions from Past Exams/RTP/MTP [As per OLD Syllabus]

Question 16: **(Dec 21)**

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?

Answer:

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:
   a) For the preparation of the financial statements in accordance with the applicable financial reporting framework;
   b) For the internal control as management considers necessary; and
   c) To provide the auditor with:

(i) Access to all information such as records, documentation and other matters;

(ii) Additional information that the auditor may request from management for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Question 17: **(Jan 21)**

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.

Answer:

1) The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.
2) Relevant ethical requirements ordinarily comprise the Code of Ethics issued by the Institute of Chartered Accountants of India.
3) 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.

Question 18: **(Nov 20)/ (RTP Nov 21)**

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

Answer:

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:

a) 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.

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

c) 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.

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

Question 19: **(RTP May 22)**

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.

Answer:

1) 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.

2) 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.

3) 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:**

      (i) A professional accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.

      (ii) A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

   b) **Objectivity:**

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

(ii) It requires that a professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

c) **Professional competence and due care:**

(i) A professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.

(ii) Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

d) **Confidentiality:**

(i) Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships.

(ii) Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

(iii) However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law.

e) **Professional behaviour:**

(i) It requires an accountant to comply with relevant laws and regulations and avoid any conduct that the accountant knows or should know might discredit the profession.

(ii) A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

Question 20: **(RTP May 22)**

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.

Answer:

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:**

Self-interest threats occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include

a) direct financial interest or materially significant indirect financial interest in a client
b) loan or guarantee to or from the concerned client
c) undue dependence on a client's fees and, hence, concerns about losing the engagement
d) close business relationship with an audit client
e) potential employment with the client and
f) contingent fees for the audit engagement

2) **Self-review threats:**

Self-review threats occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. 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 etc. Instances where such threats come into play are: -

a) when an auditor having recently been a director or senior officer of the company.
b) when auditors perform services that are themselves subject matters of audit.

3) **Advocacy threats:**

Advocacy threats 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.

4) **Familiarity threats:**

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

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

b) former partner of the audit firm being a director or senior employee of the client

c) long association between specific auditors and their specific client counterparts and

d) 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:**

Intimidation threats 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.

Question 21: **(MTP Nov 21)**

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. Explain stating clearly the information that would assist the auditor in accepting and continuing of relationship with the client.

Answer:

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:

a) The integrity of the principal owners, key management and those charged with governance of the entity;
b) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
c) Whether the firm and the engagement team can comply with relevant ethical requirements; and
d) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.



Notes:

CHAPTER

CORRECT & INCORRECT (EXTRA QUESTIONS)

Correct /Incorrect Questions

State with reasons (in short) whether the following statements are correct or incorrect:

1) Misstatement in the financial statements is always because of a fraud.
2) The first auditor of a Multi-State co-operative Society will be appointed in Annual General Meeting.
3) Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.
4) There is a very thin difference between advocacy threats and intimidation threats to an auditor while performing his duty.
5) In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population.
6) With reference to General IT control, the objective of Data Center and Network Operations is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.
7) In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater.
8) The Location of the description of the auditor's responsibilities for the audit of the financial statements is always within the body of the auditor's report.
9) Internal control cannot eliminate risk of material misstatements in the financial statements.
10) When Profit before tax from continuing operations is non-volatile, other benchmarks will be appropriate.
11) 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.
12) 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".
13) Statistical sampling being more scientific and without personal bias bias will always be appropriate to use under all circumstances.
14) 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.

15) Auditor has to disclose the impact, if any, of the pending litigations on the financial position of the auditee in his audit report.

16) 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.

17) Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence.

18) Audit findings and control deficiencies can be evaluated or assessed arbitrarily.

19) Inappropriate management can override internal controls of any organization.

20) Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same.

21) According to CARO 2020, the company auditor is required to state that whether the title deeds of all immovable properties held in the name of the company are disclosed in its financial statements.

22) SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit, that assist the auditor in preparation of the financial statements.

23) 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 with proper authorization.

24) Materiality is not a matter of size.

25) In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated.

26) Historical financial information relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.

27) The auditor shall assemble the audit documentation in the audit file and complete the administrative process of assembling the final audit file before the date of the auditor's report.

28) Where a firm is appointed as the auditor of a company, the report is signed only in the personal name of the partner signing the report.

29) The term "Analytical Procedures" means evaluation of financial information

through analysis of plausible relationships among financial data and non-financial data.

30) A company should disclose in its Annual Report, the shares in the company held by each shareholder holding more than 10 percent shares specifying the number of shares held.

31) As per SA 240, the primary responsibility of an auditor is to detect fraud and error in the financial statements.

32) Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car. The auditor is not required to include this in his CARO report.

Answers

1) **Incorrect:** Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Hence misstatement can arise from error or fraud.

Alternative solution: Misstatement 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 frame work. Hence misstatement can arise from error or fraud.

2) **Incorrect:** Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi- State Co-operative Society in the general meeting may appoint the first auditor or auditors.

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

4) **Incorrect:** 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.

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. So, it can be concluded that there is not very thin difference between the advocacy threats and intimidation threats.

5) **Incorrect:** In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

6) **Incorrect:** Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Objective of Application system acquisition, development, and maintenance is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

7) **Correct:** 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:

a) Management may be unaware of the existence of all related party relationships.

b) Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

8) **Incorrect:** The description of the auditor's responsibilities for the audit of the financial statement shall be always shown as below -

a) Within the body of the auditor's report

b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or

By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so

9) **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.

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

11) **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.

12) **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.

13) **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.

14) **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.

15) **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.

16) **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.

17) **Incorrect:** Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

18) **Incorrect:** Evaluation and assessment of audit findings and control deficiencies **involves** applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

19) **Correct:** 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.

20) **Incorrect:** 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.

21) **Incorrect:** According to CARO, 2020, the company auditor is required to state 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.

22) **Incorrect:** SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

23) **Incorrect:** 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.

24) **Incorrect:** Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example -a small amount lost by fraudulent practices of certain employees can indicate a serious flaw

in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases, quantitative limits of materiality are specified.

25) **Incorrect:** The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems. These two categories of control over IT systems are interrelated.

26) **Incorrect:** Historical financial information relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. Whereas financial information based on assumptions about occurrence of future events and possible actions by an entity relates to prospective financial information.

27) **Incorrect:** 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. 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.

Alternative reason: 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.

28) **Incorrect:** Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

Alternative Solution: 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. Whereas if a firm 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 partner signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

29) **Correct:** As per 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.

30) **Incorrect:** Schedule III to the Companies Act, 2013 requires the company to **disclose**- "shares in the company held by each shareholder holding more than **5 per cent** shares specifying the number of shares held" in notes to accounts.

31) **Incorrect:** As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. 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.

32) **Incorrect:** The auditor is required to report the same as per clause (xv) of Paragraph 3 of CARO, 2020, "whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with".

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About the Author



CA Rishabh Jain

- Having cracked the CA exam at the **age of 21**. RJ Sir became one of the youngest Chartered Accountants in India.
- He simplifies all concepts in the easiest way possible.
- His Extra-ordinary rapport/contact with students, make him highly accessible for their numerous difficulties.
- He is always available for Advice, related to CA course and beyond the course.
- He applies **simulation techniques** used by MNC's and Big 4's and provides example of actual & audit setting which in turn gives students a peek into industry methodologies.
- Only Audit Professor in India with more than **6 years'** experience in Big 4s **(PWC & Deloitte)**.
- He has mentored over 20,000 students in a short span of **10 years.**
- Engages students with real-world scenarios, from his prior experience with Fortune 500 clients.
- Mentored many of his students who are now successful professionals.
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