

CA INTER (New Syllabus)

CHAPTER: - 1

Nature,

Objective and

Scope of Audit

Q&A BOOK

By HM sir

**(Covering all Case Studies, MCQs, Correct/incorrect, TYUs and
Theoretical Questions of Study Material by ICAI)**

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 centered 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 on 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
 - 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.

Answer to Questions involving Case Studies: -

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 practicing. 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, as referred to in last para of case study. 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 APPROPRIATE 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 crore 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.

Answer to Questions involving Case Studies: -

1. (c), 2. (c), 3. (c), 4. (d), 5. (d)

MCQs based Questions

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

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

Answers to Correct/Incorrect

1. **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. **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. **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.

Test Your Understanding (1 to 6)

Test Your Understanding 1

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: Objectives of Audit:

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.

Conclusion: Thinking of Lalji Bhai is not correct.

Test Your Understanding 2

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: Scope of Audit:

An Audit of Financial Statements include within its scope the following:

(1) **Coverage of all aspects of entity:** Audit of F.S. should be organized adequately to cover all aspects of the entity relevant to the F.S.

(2) **Reliability and sufficiency of financial information:** Auditor should be reasonably satisfied that information contained in accounting records and other source data (like bills, vouchers, documents etc.) is reliable and provide sufficient basis for preparation of F.S.

(3) **Proper disclosure of financial information:** Auditor should decide whether relevant information is properly disclosed in F.S in compliance with applicable statutory requirements. For this purpose, auditor is required to study and assess accounting systems and internal controls.

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

Test Your Understanding 3

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: Examination of Books of Accounts for a specific purpose:

An Audit is independent examination of Financial Information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.

Audit is not an official investigation into alleged wrong doing.

In this case, CA was appointed 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.

Conclusion: Work performed by CA is nature of investigation and hence his report will not be in nature of audit report.

Test Your Understanding 4

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: Inherent Limitations of an Audit:

An Audit suffers from inherent limitations due to which auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the F.S. are free from material misstatement due to fraud or error.

Circumstances as given in questions is an 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.

Conclusion: Partners of the firm are not correct. This is an inherent limitation of audit

Test Your Understanding 5

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: Review Engagement:

Raja & Co. can provide a review report in this case. Review is a limited assurance engagement and involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.

Hence Raja & Co. can provide a report as requested by management of Exotic Tours and Travels Limited. Such report would be in nature of "Review".

Raja & Co. will be required to obtain sufficient appropriate evidence based on limited procedures performed.

Test Your Understanding 6

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: Duties in relation to Engagement and Quality Control Standards:

It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them.

However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, professional accountant is required to ensure the following:

- a) Document how alternative procedures performed to achieve the purpose of required procedure;
- b) Reason for departure has also to be documented;
- c) Report should draw attention to such departures.

Conclusion: CA P Babu is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented. His report should draw attention to such departure.

Theoretical Questions

1. "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: - Selection of Accounting Policies:

Choosing of appropriate accounting policies is responsibility of management. Role of auditor lies in evaluating selection and consistent application of accounting policies by management.

Auditor's duties in relation to accounting policies includes

- a) to evaluate whether accounting policies selected by management are proper and
- b) whether chosen policy has been applied consistently on a period-to-period basis.

2. Assurance engagements are not restricted to audit of financial statements alone. Discuss.

Answer: - Assurance engagements:

- Assurance Engagement is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
- Scope of Assurance Engagements is not restricted to audit of financial statements only; it also extends to examination of Prospective Financial Information (PFI) and examination of internal controls.
- Examples of various assurance engagements that can be rendered by a practitioner includes the following:
 1. Audit of F.S. – Reasonable assurance engagement
 2. Review of F.S. – Limited assurance engagement
 3. Examination of PFI – Provides assurance regarding reasonability of assumptions forming basis of projections and related matters.
 4. Report on controls operating at an organization – Provides assurance regarding design and operation of controls.

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

Answer: - Three Party relationship of assurance engagement:

An assurance engagement involves three parties – a practitioner, a responsible party, and intended users.

1. **Practitioner:** Person who provides the assurance. Practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
2. **Responsible party:** Party responsible for preparation of subject matter.
3. **Intended users:** Persons for whom an assurance report is prepared. These persons may use the report in making decisions.

4. 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: - Examination of Accounts for Determining Existence of Fraud:

- Assurance engagement is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
- Reasonable Assurance requires a high, but absolute assurance.
- In this case, a Chartered Accountant is specifically asked to check accounts whether fraud exists.

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

5. 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: - Inherent Limitations of an Audit - Nature of Audit procedures:

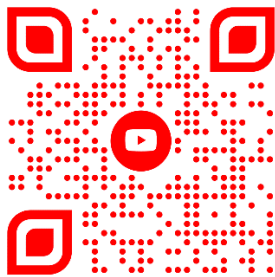
There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- (1) 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 requested. In case he is not provided

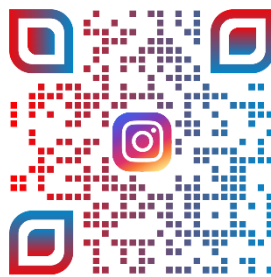
with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.

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.

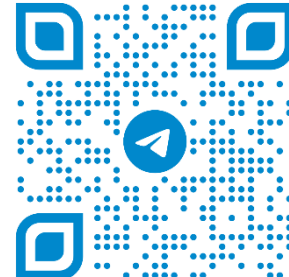
It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.



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