

Chapter 3 - Audit Risk and Risk Assessment

Part I : Descriptive Questions

Audit Risk

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| Q1. | 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. (ICAI Study Material - Test Your Understanding) |
| | 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 . |
| Q2. | 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? (ICAI Study Material - Test Your Understanding) |
| | 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 .” |
| Q3. | 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. (ICAI Study Material - Test Your Understanding) |
| | 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 ” |
| Q4. | 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? (ICAI Study Material - Test Your Understanding) |
| | 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 is “ detection risk ”. |
| Q5. | A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year 2023-24. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question (ICAI Study Material - Illustration) |
| | The risk mentioned in the question is known as Audit Risk , because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk. |
| Q6. | XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis. Discuss the types of inherent, control and detection risks as perceived by the auditor (ICAI Study Material - Illustration) |
| | <ul style="list-style-type: none"> ● Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate. ● Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be |

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| | <p>there and risk to auditor would again be that inventory records would be inaccurate.</p> <ul style="list-style-type: none"> ● Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, inquiries, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated. |
| Q7. | <p>“Risk of material misstatement consists of two components” Explain clearly defining risk of material misstatement. (ICAI Study Material - Test Your knowledge)</p> <p>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.</p> <ul style="list-style-type: none"> ● 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 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. |
| Q8. | <p>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 (ICAI Study Material - Test Your Knowledge) (RTP, Nov 2019, NA)</p> <p>Combined Assessment of the Risk of Material Misstatement</p> <ul style="list-style-type: none"> ● The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. ● The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. ● It can be concluded from the above that Risk of Material Misstatement = Inherent Risk x Control Risk |
| Q9. | <p>The assessment of risks is a matter of professional judgment. Explain stating clearly what is not included in Audit Risk? (MTP1, Nov 2018, 5 Marks)</p> <p>Assessment of Risks - Matter of Professional Judgement</p> <ul style="list-style-type: none"> ● Audit risk is the risk that the auditor expresses an inappropriate opinion when the FSs are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk . ● The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. ● The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. <p>What is not included in Audit Risk?</p> <ul style="list-style-type: none"> ● Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. ● Audit risk is a technical term related to the process of auditing; it does not refer to the auditor’s business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements. |
| Q10. | <p>The risks of material misstatement may exist at the financial statement level and assertion level. Explain the two levels. (RTP, Nov 2020, NA)</p> <p style="text-align: center;">OR</p> <p>Risk of material misstatement refers to the risk that the financial statements are materially misstated prior to audit. Discuss the levels at which this risk exists. (RTP, Nov 2023, NA)</p> <p>The risks of material misstatement may exist at two levels:</p> <ul style="list-style-type: none"> ● The overall financial statement level- Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect |

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| | <p>many assertions.</p> <ul style="list-style-type: none"> • The assertion level for classes of transactions, account balances, and disclosures - Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk |
| Q11. | <p>You are appointed as an auditor of Gama Ltd. Your audit assistant wants to understand the meaning of Audit Risk. Explain him the meaning of Audit Risk with example. Also guide him as to what is not included in Audit Risk. (SA, May 2023, 4 marks)</p> <p>Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.</p> <p>Example: Gama Limited purchased a Plant and Machinery for ₹ 2 Crores in the financial year 2023-2024. The accountant of Gama limited debited ₹ 2 crores in the repair and maintenance account in the statement of Profit and loss instead of taking it to the balance sheet as PPE and claim depreciation on it. While auditing the accounts of this company the auditor may not notice this and consequently may not report anything regarding the plant and machinery. Therefore, the opinion given by the auditor would be inappropriate resulting in audit risk.</p> <p>What is not included in Audit Risk?</p> <ul style="list-style-type: none"> • Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. • Further, audit risk is a technical term related to the process of auditing. It does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements. |

Risks that require special audit consideration

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| Q12. | <p>"As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, state the factors which shall be considered by the auditor. Explain the above in context of SA-315." (RTP, May 2018, NA)</p> <p style="text-align: center;">OR</p> <p>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. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.</p> <p>In the context of significant risk, explain the factors to be considered by the auditor in exercising judgment as to which risks are significant risks. (RTP, Nov 2021, NA) (MTP1, Nov 2023, 4 marks)</p> <p style="text-align: center;">OR</p> <p>In exercising judgment as to which risks are significant risks, the auditor shall consider various factors. Explain. (MTP2, Nov 2022, 4 Marks)</p> <p style="text-align: center;">OR</p> <p>As a part of Risk assessment, the auditor shall determine whether any of the risks identified are in the auditor's judgement a significant risk. Mention any three guiding factors to judge as to which risks are significant risks? (SA, May 2023, 3 marks)</p> |
| | <p>In exercising judgment as to which risks are significant risks, the auditor shall consider the following-</p> <ul style="list-style-type: none"> • Whether the risk is a risk of fraud; • Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention; • The complexity of transactions; • Whether the risk involves significant transactions with related parties; • The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and • Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual. |

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| Q13. | Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as complex calculations. Also, risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as accounting principles for accounting estimates may be subject to differing interpretation etc. Explain in detail (RTP, Nov 2021, NA) (MTP2, Nov 2023, 3 marks) |
| | <p>Risks of Material Misstatement– Greater for Significant Non-Routine Transactions:</p> <p>Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:</p> <ul style="list-style-type: none"> ● Greater management intervention to specify the accounting treatment. ● Greater manual intervention for data collection and processing. ● Complex calculations or accounting principles. ● The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks. <p>Risks of material misstatement– Greater for Significant Judgmental Matters:</p> <p>Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:</p> <ul style="list-style-type: none"> ● Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretations. ● Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value. |
| Q14. | <p>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 (SA, Dec 2021, 3 Marks)</p> <p style="text-align: center;">OR</p> <p>What is understood by “non-routine” transactions? Briefly outline why risks of material misstatement is greater for such transactions. (ICAI Study Material - Test Your Knowledge)</p> |
| | <p>Risk of Material Misstatement – Greater for Significant Non-Routine Transactions:</p> <p>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.</p> <p>Risks of Material Misstatement– Greater for Significant Non-Routine Transactions</p> <p>Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:</p> <ul style="list-style-type: none"> ● Greater management intervention to specify the accounting treatment. ● Greater manual intervention for data collection and processing. ● Complex calculations or accounting principles. ● The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks. <p>Keeping in view above, view of the Auditor of Sunshine Ltd is correct.</p> |

SA 315 Identifying and assessing the risk of material misstatement through understanding the entity and its environment

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| Q15. | <p>The auditor shall identify and assess the risks of material misstatement at both levels to provide a basis for designing and performing further audit procedures. For the purpose of Identifying and assessing the risks of material misstatement the auditor shall Identify risks, assess the identified risks, relate the identified risks and consider the likelihood of misstatement. Explain the above in detail. (MTP2, Nov 2018, 5 Marks)</p> <p style="text-align: center;">OR</p> <p>For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points. (RTP, Nov 2020, NA)</p> |
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| OR |
| Discuss the steps to be taken by the auditor for the purpose of Identifying and assessing the risks of material misstatement as per SA 315. (MTP1, Nov 2022, 4 Marks) |
| <p>Identify and assess the risks of material misstatement:</p> <p>The auditor shall identify and assess the risks of material misstatement at:</p> <ul style="list-style-type: none"> ● the financial statement level - ● the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures <p>For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:</p> <ul style="list-style-type: none"> ● Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; ● Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions; ● Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and ● Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement. |

Risk assessment procedures

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| Q16. | <p>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? (ICAI Study Material - Test Your Understanding)</p> |
| | <p>It is noticed by the auditor that the current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). 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. 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.</p> |
| Q17. | <p>Discuss how “analytical procedures” performed as “risk assessment procedures” can be useful to an auditor (ICAI Study Material - Test Your Knowledge)</p> |
| | OR |
| | <p>Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail. (RTP, Nov 2020, NA)</p> |
| | OR |
| | <p>Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware. Explain (RTP, Nov 2023, NA)</p> |
| | <ul style="list-style-type: none"> ● Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. ● Analytical procedures performed as risk assessment procedures may include both financial and non-financial information. ● Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. ● Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. ● However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, |

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| | <p>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.</p> |
| Q18. | <p>"Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. Explain with the help of examples." (RTP, Nov 2020, NA)</p> <p style="text-align: center;">OR</p> <p>The risk assessment procedures shall include the 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. Explain giving at least three examples. (MTP1, Nov 2022, 3 Marks)</p> <p style="text-align: center;">OR</p> <p>Management is often in the best position to perpetrate fraud. As an auditor you are suspecting existence or suspicion of fraud from management. Give any three examples of "others within the entity" to whom direct inquiries can be made. (SA, May 2023, 3 marks)</p> <p>Inquiries of Management and Others Within the Entity: Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.</p> <p>Examples</p> <ul style="list-style-type: none"> ● Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ● Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control ● Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies. ● Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud. ● Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers. ● Inquiries directed to the risk management function may provide information about operational and regulatory risks that may affect financial reporting. ● Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks. |
| Q19. | <p>CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations (SA, July 2021, 3 Marks)</p> <p>Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.</p> <p>Examples of audit procedures which include observation or inspection of the following:</p> <ul style="list-style-type: none"> ● Entity's operations ● Documents (such as business plans and strategies), records, and internal control manuals. ● Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings) ● The entity's premises and plant facilities |

Understanding the Entity and its Environment

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| Q20. | <p>The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed. (ICAI Study Material - Illustration)</p> |
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| | Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The auditor should proceed accordingly. |
| Q21. | <p>While auditing the books of accounts of Heavy Material Limited for the financial year 2022-23, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer. (ICAI Study Material - Illustration)</p> <p>The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of the audit of that company.</p> |
| Q22. | <p>Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment. (ICAI Study Material - Illustration)</p> <p>While understanding the entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.</p> |
| Q23. | <p>In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment". (MTP1, Nov 2019, 4 Marks)</p> <p style="text-align: center;">OR</p> <p>Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with relevant SA, knowledge to be obtained by the auditor in establishing overall plan. Also explain how such an understanding would be helpful to the auditor. (RTP, May 2021, NA)</p> <p style="text-align: center;">OR</p> <p>CA D has been appointed as an auditor of LMP Ltd. Before developing an overall audit plan, CA D wants to get an understanding and knowledge of the Client's business including applicable financial reporting framework. Guide CA D in understanding of the same with reference to the relevant Standard on Auditing. (SA, May 2023, 4 marks)</p> <p>As per SA 315 – "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the following:</p> <ul style="list-style-type: none"> ● Relevant industry, regulatory, and other external factors including the applicable financial reporting framework ● The nature of the entity, including: <ul style="list-style-type: none"> ○ its operations; ○ its ownership and governance structures; ○ the types of investments that the entity is making and plans to make and ○ the way that the entity is structured and how it is financed; ● The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. ● The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. ● The measurement and review of the entity's financial performance. |
| Q24. | <p>Knowledge of the Client's business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Substantiate with the help of examples. (RTP, May 2020, NA)</p> <ul style="list-style-type: none"> ● Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. |

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| | <ul style="list-style-type: none"> ○ Examples of matters the auditor may consider include market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products. ● Relevant regulatory factors include the regulatory environment. The regulatory environment includes, among other matters, the applicable financial reporting framework and the legal and political environment. <ul style="list-style-type: none"> ○ Examples of matters the auditor may consider include accounting principles and industry specific practices, regulatory framework for a regulated industry, legislation and regulation that significantly affect the entity's operations, including direct supervisory activities, taxation, government policies currently affecting the conduct of the entity's business, environmental requirements affecting the industry and the entity's business. ● Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation etc. |
| Q25. | <p>Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples. (RTP, May 2020, NA) (RTP, Nov 2023, NA)</p> <p>Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:</p> <ul style="list-style-type: none"> ● Assessing risks of material misstatement of the financial statements; ● Determining materiality in accordance with SA 320; ● Considering the appropriateness of the selection and application of accounting policies; ● Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions; ● Developing expectations for use when performing analytical procedures; ● Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations. |

Part II: Correct/Incorrect Questions

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| Q1. | <p>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. (ICAI Study Material - Test Your Knowledge) (RTP, May 2018, NA) (MTP2, Nov 2023, 2 marks)</p> <p>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.</p> <p>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.</p> |
| Q2. | <p>The assessment of risks is a matter capable of precise measurement. (MTP1, May 2018, 2 Marks) (MTP1, Nov 2018, 2 Marks) (MTP1, May 2019, 2 Marks) (RTP, Nov 2019, NA)</p> <p>Incorrect. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.</p> |
| Q3. | <p>Obtaining an understanding of the entity and its environment, including the entity's internal control is a one time process of gathering, updating and analysing information before the audit. (MTP2, May 2018, 2 Marks)</p> <p>Incorrect. Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit.</p> |

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| Q4. | <p>The assessment of risks is a matter of professional judgement. (MTP2, Nov 2018, 2 Marks)</p> <p>Correct. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement</p> |
| Q5. | <p>The SAs ordinarily refer to inherent risk and control risk separately. (RTP, Nov 2018, NA) (RTP, May 2019, NA)</p> <p>Incorrect. The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms.</p> |
| Q6. | <p>Judgemental matters are transactions that are unusual due to either its size or nature and that therefore occur infrequently. (SA, Nov 2018, 2 Marks)</p> <p>Incorrect. Significant risks often relate to significant non-routine transactions or judgemental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgemental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Thus judgemental matters are not always unusual due to their size or nature.</p> |
| Q7. | <p>There is no relation between Inherent risk, Control risk and Detection risk. (MTP1, Nov 2019, 2 Marks)</p> <p style="text-align: center;">OR</p> <p>There is direct relationship between detection risks and the combined level of inherent and control risks. (RTP, Nov 2023, NA)</p> <p>Incorrect. There is an inverse relationship between detection risks and the combined level of inherent and control risks. When inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. When inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risks to an acceptably low level.</p> |
| Q8. | <p>For an auditor, the Risk assessment procedure provides sufficient appropriate audit evidence to base the audit opinion. (SA, Nov 2019, 2 Marks) (MTP2, May 2023, 2 marks)</p> <p>Incorrect. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.</p> |
| Q9. | <p>Risk assessment procedures are not performed to obtain an understanding of the entity and its environment. (RTP, May 2020, NA)</p> <p>Incorrect. Risk assessment procedures refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.</p> |
| Q10. | <p>Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates. (SA, Nov 2020, 2 Marks)</p> <p>Correct. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:</p> <ul style="list-style-type: none"> • Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretations. • Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value. |
| Q11. | <p>The SAs do not ordinarily refer to inherent risk and control risk separately. (MTP2, Nov 2021, 2 Marks) (MTP1, May 2022, 2 marks)</p> |

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| | Correct. The SAs do not ordinarily refer to inherent risk and control risk separately , but rather to a combined assessment of the “risks of material misstatement”. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in nonquantitative terms. |
| Q12. | There is an inverse relationship between detection risks and the combined level of inherent and control risks (MTP2, May 2022, 2 marks) (RTP, Nov 2022, NA) |
| | Correct. There is an inverse relationship between detection risks and the combined level of inherent and control risks . For example, when inherent and control risks are high, acceptable detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risks and still reduce audit risks to an acceptably low level. |
| Q13. | According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, only at assertion level. (RTP, May 2023, NA) |
| | Incorrect. According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement , whether due to fraud or error, at the financial statement and assertion levels , through understanding the entity and its environment, including the entity's internal control |

Part III: Multiple Choice Questions

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| Q1. | Components of risk of material misstatement at the assertion level are : (a) Inherent risk and detection risk (b) inherent risk and control risk (c) control risk and detection risk (d) inherent risk, control risk and detection risk (Sample MCQs) (ICAI MCQs) |
| | Correct answer: (b) inherent risk and control risk Explanation: <ul style="list-style-type: none"> • Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components - inherent risk and control risk • Meaning of Inherent Risk - it is assumed that there is a risk within the entity irrespective of whether controls are present or not • Meaning of Control risk - controls placed by the management are not able to prevent, detect and correct material misstatements |
| Q2. | Audit risk is a function of the (a) risks of material misstatement and detection risk (b) audit risk and detection risk. (c) control risk and detection risk. (d) inherent risk and detection risk. (Sample MCQs) (ICAI MCQs) (MTP2, May 2019, 1 Mark) (MTP2, May 2021, 2 Marks) |
| | Correct answer: (a) risks of material misstatement and detection risk Explanation: Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment. Audit Risk = Risk of Material Misstatement and Detection Risk, where Risk of Material Misstatement = inherent and control risk. |
| Q3. | Risk of material misstatement may be defined as the risk (a) that the financial statements are materially misstated after audit (b) that the financial statements are materially misstated during audit. (c) that the financial statements are materially misstated prior to audit. |

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| | <p>(d) All of the above (Sample MCQs) (ICAI MCQs) (MTP2, May 2019, 1 Mark) (MTP1, Nov 2019, 1 Mark)(MTP2, May 2021, 2 Marks) (MTP2, Nov 2021, 2 Marks)</p> |
| | <p>Correct answer: (c) that the financial statements are materially misstated prior to audit. Explanation: Risk of material misstatement may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components - inherent risk and control risk.</p> |
| Q4. | <p>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 is - (a) Control Risk (b) Inherent Risk (c) Detection Risk (d) Audit Risk (Sample MCQs) (ICAI MCQs)</p> |
| | <p>Correct answer: (b) Inherent Risk Explanation: Meaning of different terms are explained below:</p> <ul style="list-style-type: none"> • Inherent risk- it is assumed that there is a risk within the entity irrespective of whether controls are present or not • Control risk - controls placed by the management are not able to prevent, detect and correct material misstatements • Detection risk - auditor's procedures may not be able to detect the risk. • Audit Risk - risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. |
| Q5. | <p>The assessment of risks is a (a) matter capable of precise measurement rather than matter of professional judgment (b) matter of professional judgment, rather than a matter capable of precise measurement. (c) matter of professional judgement as well as capable of precise measurement sometimes. (d) None of the above (Sample MCQs) (ICAI MCQs)</p> |
| | <p>Correct answer: (b) matter of professional judgment, rather than a matter capable of precise measurement.</p> |
| Q6. | <p>For a given level of audit risk, the acceptable level of detection risk bears _____relationship to the assessed risks of material misstatement at the assertion level. (a) direct. (b) Inverse (c) no relationship (d) either (a) or (c) (ICAI MCQs)</p> |
| | <p>Correct answer: (b) Inverse Explanation: For example, if an entity has a low ROMM (IR*CR), that means the auditor shall do less checking, which means fewer samples have been drawn from the population, which also means a high materiality level would be set. Less checking means that there is a major portion that is not checked by an auditor or that many errors are undetected. (If a high materiality level is set, transactions or account balances below the materiality level are not checked.) So, the detection risk here is high, i.e., the auditor's procedures may not be able to detect the risk.</p> |
| Q7. | <p>Risk of material misstatement has _____ components (a) one (b) two (c) three (d) four (ICAI MCQs)</p> |

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| | Correct answer: (b) two |
| Q8. | <p>Controls can be_____related to an assertion.</p> <p>(a) directly (b) indirectly (c) directly or indirectly (d) no relationship between controls and assertion.</p> <p>(ICAI MCQs)</p> |
| | Correct answer: (c) directly or indirectly |
| Q9. | <p>The assessment of the risks of material misstatement may be expressed in</p> <p>(a) quantitative terms, such as in percentages, or in non-quantitative terms. (b) quantitative terms, such as in percentages, (c) non-quantitative terms. (d) None of the above</p> <p>(Sample MCQs) (ICAI MCQs) (MTP1, Nov 2019, 1 Mark)</p> |
| | Correct answer: (a) quantitative terms, such as in percentages, or in non-quantitative terms |
| Q10. | <p>_____refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.</p> <p>(a) Audit assessment procedures (b) substantive procedures (c) test of control (d) Risk assessment procedures</p> <p>(Sample MCQs) (ICAI MCQs) (RTP, Nov 2019, NA) (RTP, May 2022, NA)</p> |
| | Correct answer: (d) Risk assessment procedures |
| Q11. | <p>SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement -</p> <p>(a) at the financial statement levels only. (b) at the assertion levels only. (c) at the financial statement and assertion levels. (d) at the financial statement or assertion levels.</p> <p>(ICAI MCQs) (MTP1, May 2019, 1 Mark) (MTP1, Nov 2019, 1 Mark)</p> |
| | Correct answer: (c) at the financial statement and assertion levels |
| Q12. | <p>Which of the following is incorrect for the purpose of Identifying and assessing the risks of material misstatement, the auditor shall :</p> <p>(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (d) Not consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.</p> <p>(ICAI MCQs) (MTP1, May 2023, 1 mark)</p> |
| | Correct answer: (d) Not consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement |

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| Q13. | The risks of material misstatement at the assertion level consist of two components: (a) Inherent risk and detection risk (b) control risk and detection risk (c) audit risk and detection risk (d) Inherent risk and control risk (MTP1, May 2019, 1 Mark) |
| | Correct answer: (d) Inherent risk and control risk |
| Q14. | The risk that the financial statements are materially misstated prior to audit is called- (a) Risk of material misstatement (b) detection risk (c) audit risk (d) significant risk (MTP1, May 2021, 1 Mark) |
| | Correct answer: (a) Risk of material misstatement |

Chapter 3A - Internal Control

Part I : Descriptive Questions

Internal Control- Meaning, Benefits and Limitations

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| Q1. | Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard. (ICAI Study Material - Illustration) |
| | <p>Understanding Internal Controls:</p> <ul style="list-style-type: none"> ● The auditor shall obtain an understanding of internal control relevant to the audit. ● Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. ● It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. |
| Q2. | The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit (ICAI Study Material - Illustration) |
| | <p>Understanding Internal Controls:</p> <p>The view of the team member of the auditor is incorrect because understanding the internal control of the company would help the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company</p> |
| Q3. | 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. (ICAI Study Material - Test Your Knowledge) (RTP, May 2020, NA) |
| | <ul style="list-style-type: none"> ● Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. ● The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. ● 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. <p>Objectives of Internal Control are :</p> <ul style="list-style-type: none"> ● transactions are executed in accordance with management's general or specific authorization; ● 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; ● assets are safeguarded from unauthorised access, use or disposition; and ● the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences. |
| Q4. | Auditor GR and Associates have been appointed to conduct audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditors do not think that it would be necessary to understand internal controls. Advise the auditor in this regard explaining clearly the benefits of understanding the internal control. (RTP, May 2021, NA) |
| | The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. |

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| | <p>Benefits of Understanding the Internal Control: An understanding of internal control assists the auditor in:</p> <ul style="list-style-type: none"> • identifying types of potential misstatements; • identifying factors that affect the risks of material misstatement, and • designing the nature, timing, and extent of further audit procedures. |
| Q5. | <p>Briefly discuss the limitations of Internal Control (SA, May 2018, 6 Marks) (MTP2, May 2019, 4 Marks) (RTP, May 2023, NA)</p> <p>Limitations of Internal Control:</p> <ul style="list-style-type: none"> • Internal control can provide only reasonable assurance: Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. • Human judgment in decision-making: Realities that human judgment in decision making can be faulty and that breakdowns in internal control can occur because of human error. • Lack of understanding the purpose: Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action. • Collusion among People: Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. • Judgements by Management: Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume. • Limitations in case of Small Entities: Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. |
| Q6. | <p>ABC Ltd. has many divisions and branches across the country. They have an internal control system which is well established maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company (SA, Nov 2022, 3 marks)</p> <p>Meaning and benefits of understanding Internal Control:</p> <p>Meaning of Internal Control: As per SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to</p> <ul style="list-style-type: none"> • reliability of financial reporting, • effectiveness and efficiency of operations, • safeguarding of assets, and • compliance with applicable laws and regulations. <p>Benefits of Understanding the Internal Control: An understanding of internal control assists the auditor in:</p> <ul style="list-style-type: none"> • identifying types of potential misstatements; • identifying factors that affect the risks of material misstatement, and • designing the nature, timing, and extent of further audit procedures. |

Components of Internal Control

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| Q7. | <p>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? (ICAI Study Material - Test Your Understanding)</p> |
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| | <p>The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding the HR function of the company. It, in turn, helps in understanding the control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.</p> |
| Q8. | <p>During the audit of 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.</p> <p>(ICAI Study Material - Test Your Understanding)</p> <ul style="list-style-type: none"> • 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. |
| Q9. | <p>“The auditor shall obtain an understanding of the control environment” Explain stating what is included in control environment. (ICAI Study Material - Test Your Knowledge)</p> <p style="text-align: center;">OR</p> <p>The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:</p> <ol style="list-style-type: none"> i) Management has created and maintained a culture of honesty and ethical behavior; and ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control. <p>Advise what is included in the control environment. Also explain the elements of the control environment.</p> <p>(RTP, May 2018, NA) (MTP1, May 2018, 6 Marks) (MTP1, Nov 2018, 5 Marks) (MTP1, May 2019, 6 Marks) (MTP1, May 2020, 4 Marks)</p> <p style="text-align: center;">OR</p> <p>The auditor of FAST CARS Ltd obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether management has created and maintained a culture of honesty and ethical behaviour and the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control. Advise what is included in control environment. Also explain the elements of control environment.</p> <p>(RTP, Nov 2019, NA)</p> |
| | <p>What is included in the Control Environment?</p> <p>The control environment includes:</p> <ul style="list-style-type: none"> • the governance and management functions and • the attitudes, awareness, and actions of those charged with governance and management. <p>The control environment sets the tone of an organization, influencing the control consciousness of its people.</p> <p>Elements of the Control Environment:</p> <ol style="list-style-type: none"> 1. Communication and enforcement of integrity and ethical values – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls. 2. Commitment to competence – Matters such as management’s consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge. 3. Participation by those charged with governance – It includes attributes of those charged with governance such as their independence from management, their experience and stature, the extent of their involvement and the information they receive and the scrutiny of activities 4. Management’s philosophy and operating style – Characteristics such as management’s: <ul style="list-style-type: none"> • Approach to taking and managing business risks. • Attitudes and actions toward financial reporting. • Attitudes toward information processing and accounting functions and personnel. 5. Organisational structure – The framework within which an entity’s activities for achieving its objectives are planned, executed, controlled, and reviewed. |

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| | <p>6. Assignment of authority and responsibility - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.</p> <p>7. Human resource policies and practices – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.</p> |
| Q10. | <p>The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting” Explain. (ICAI Study Material- Test Your Knowledge)</p> <p style="text-align: center;">OR</p> <p>Define Monitoring of Controls and in respect of monitoring of controls, answer the following questions:</p> <ol style="list-style-type: none"> i) How monitoring of controls would be helpful in assessing the effectiveness of controls? ii) How can management accomplish monitoring of controls? iii) What is included in the Management’s monitoring activities? <p>(RTP, Nov 2022, NA)</p> <p>Monitoring of controls is a process to assess the effectiveness of internal control performance over time.</p> <ol style="list-style-type: none"> i) Monitoring of controls helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. ii) Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities. iii) Management’s monitoring activities 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 |
| Q11. | <p>“A satisfactory control environment is not an absolute deterrent to fraud although it may help reduce the risk of fraud.” Explain. (RTP, May 2018, NA)</p> <p style="text-align: center;">OR</p> <p>The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyse and explain. (RTP, May 2019, NA)</p> <p>Satisfactory Control Environment - not an absolute deterrent to fraud:</p> <p>The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud.</p> <p>For example, management’s failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As per SA 330, the control environment also influences the nature, timing, and extent of the auditor’s further procedures.</p> <p>The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor’s evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor’s assessment of the risks of material misstatement.</p> |
| Q12. | <p>The auditor of PQR Ltd, a company engaged in the manufacturing of Auto parts obtains an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. Auditor is of the view that he requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process. Advise explaining the meaning of control activities. Also identify and explain the control activities which are relevant to the audit (MTP2, May 2018, 6 Marks)</p> <p style="text-align: center;">OR</p> <p>The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. Explain in detail stating clearly the meaning of control activities and also discuss control activities that are relevant to the audit. (RTP, May 2021, NA)</p> <p>Control Activities - Component of Internal Control</p> |

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| | <p>The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. An audit requires an understanding of only those control activities related to a significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.</p> <p>Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following</p> <ul style="list-style-type: none"> ● Authorization ● Segregation of Duties ● Physical controls ● Information processing ● Performance reviews <p>Control activities that are relevant to the audit are:</p> <ul style="list-style-type: none"> ● Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.; or ● Those that are considered to be relevant in the judgment of the auditor. ● As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. |
| Q13. | <p>The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control. (MTP1, Nov 2020, 4 Marks) (MTP1, Nov 2021, 3 Marks) (RTP, May 2023, NA) (MTP1, May 2023, 3 marks)</p> <p>The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:</p> <ul style="list-style-type: none"> ● The control environment; ● The entity's risk assessment process; ● Monitoring of controls. ● Control activities; and ● The information system, including the related business processes, relevant to financial reporting, and communication; |
| Q14. | <p>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. (SA, Nov 2020, 4 Marks)</p> <p>Monitoring of Controls: Component of Internal Control</p> <p>The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting. Monitoring of controls is a process to assess the effectiveness of internal control performance over time.</p> <ul style="list-style-type: none"> ● Monitoring of controls helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. ● 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. ● 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. ● Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control. |
| Q15. | <p>The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard. (RTP, May 2021, NA) (MTP2, May 2022, 4 marks)</p> |

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| | <p style="text-align: center;">OR</p> <p>The auditor obtains an understanding of the information system, including the related business processes, relevant to financial reporting to gain insight of this important component of internal control. What are the specific areas in respect of which auditor gains such understanding? (MTP1, Nov 2023, 4 marks)</p> |
| | <p>The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as:</p> <ul style="list-style-type: none"> ● The classes of transactions in the entity's operations that are significant to the financial statements; ● The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; ● The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; ● How the information system captures events and conditions that are significant to the financial statements; ● The financial reporting process used to prepare the entity's financial statements; ● Controls surrounding journal entries. |
| Q16. | <p>Explain what understanding should an auditor obtain regarding an entity's risk assessment process (one of the components of the internal control of the entity). (MTP2, Nov 2022, 3 Marks)</p> <p>The Entity's Risk Assessment Process– Component of Control Environment</p> <p>The auditor shall obtain an understanding of whether the entity has a process for:</p> <ul style="list-style-type: none"> ● Identifying business risks relevant to financial reporting objectives; ● Estimating the significance of the risks; ● Assessing the likelihood of their occurrence; and ● Deciding about actions to address those risks. <p>The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment .</p> |
| Q17. | <p>Z Ltd. is a manufacturer of ready-made garments. During the year 2022-23, they have opened two new branches and there is a substantial increase in their sales. The management has appointed CA R to review the internal control system of the company as they feel that there are lapses in the control environment of the company. What is included in the control environment and what will the auditor evaluate in order obtain an understanding of the control environment? (SA, Nov 2022, 3 marks)</p> <p>The control environment includes:</p> <ul style="list-style-type: none"> ● the governance and management functions and ● the attitudes, awareness, and actions of those charged with governance and management . <p>The control environment sets the tone of an organization, influencing the control consciousness of its people.</p> <p>The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:</p> <ul style="list-style-type: none"> ● Management has created and maintained a culture of honesty and ethical behavior; and ● The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control. |

Are all Controls Relevant to the audit?

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| Q18. | <p>Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, the significance of the related risk etc. Explain in detail. (RTP, May 2021, NA) (MTP1, May 2022, 3 marks)</p> <p style="text-align: center;">OR</p> <p>Explain the matters which should be included for factors relevant to the auditors' judgement about whether a control is relevant to the audit. (RTP, Nov 2022, NA)</p> |
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There is a **direct** relationship between an **entity's objectives** and the **controls** implemented to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, **not all** of these objectives and controls are **relevant** to the auditor's risk assessment.

Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- **Materiality.**
- The significance of the related **risk**.
- The **size** of the entity.
- The **nature** of the entity's business, including its organisation and ownership characteristics.
- The diversity and **complexity** of the entity's operations.
- Applicable **legal** and **regulatory** requirements.
- The circumstances and the applicable **component** of internal **control**.
- The **nature** and **complexity** of the **systems** that are part of the entity's internal control, including the use of service organisations.
- Whether, and how, a specific control, **individually** or in **combination** with others, **prevents**, or **detects** and **corrects**, material misstatement.

Nature and Extent of the Understanding of Relevant Controls

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| Q19. | Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls (RTP, May 2018, NA) |
| | Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include- <ul style="list-style-type: none"> ● Inquiring of entity personnel ● Observing the application of specific controls. ● Inspecting documents and reports. ● Tracing transactions through the information system relevant to financial reporting |

Evaluation of Internal Control System

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| Q20. | 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? (ICAI Study Material - Test Your Understanding) |
| | In a small company, control systems are basic and not formalized . Therefore, auditor should proceed to evaluate internal control using narrative record. |
| Q21. | Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y. (ICAI Study Material - Illustration) |
| | The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets . |
| Q22. | Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise. (ICAI Study Material - Illustration) |
| | The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive . |
| Q23. | In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above. (ICAI Study Material - Illustration) |

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| | <p>The method of evaluation of internal control used in the above question is known as Internal Control Questionnaire because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.</p> |
| Q24. | <p>Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above. (ICAI Study Material - Illustration)</p> <p>The method of evaluation of internal control referred above is known as Narrative Record because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.</p> |
| Q25. | <p>A Flow Chart is a graphic presentation of each part of the company's system of internal control. Explain elaborating each and every aspect about flow chart. (RTP, Nov 2018, NA)</p> <p>Flow Chart:</p> <ul style="list-style-type: none"> • It is a graphic presentation of each part of the company's system of internal control. • It is the most concise way of recording the auditor's review of the system. • It minimises the amount of narrative explanation and thereby achieves a presentation not possible in any other form. • It gives bird's eye view of the system and the flow of transactions. • This will help him to understand and evaluate the internal controls in the correct perspective and identify deficiencies |
| Q26. | <p>The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. Analyse and explain. (RTP, Nov 2018, NA)</p> <p style="text-align: center;">OR</p> <p>The extent and the nature of the audit programme is substantially influenced by the internal control system in operation. Analyse and explain. (RTP, Nov 2019, NA)</p> <ul style="list-style-type: none"> • The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. • It would be better if the auditor can undertake the review of the internal control system of the client. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed. • A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme. • In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction |
| Q27. | <p>So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. Explain stating clearly the benefits of evaluation of internal control to the auditor. (RTP, May 2019, NA)</p> <p style="text-align: center;">OR</p> <p>The review of internal controls will enable the auditor to know the areas where control is weak. Explain stating clearly the benefits of evaluation of internal control to the auditor. (RTP, Nov 2022, NA)</p> <p>Benefits of Evaluation of Internal Control to the Auditor</p> <p>The review of internal controls will enable the auditor to know:</p> |

- whether **errors** and **frauds** are likely to be located in the ordinary course of operations of the business;
- whether an **adequate internal control system** is in use and **operating** as planned by the management;
- whether an effective **internal auditing department** is operating;
- whether any **administrative control** has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
- whether the controls adequately **safeguard the assets**;
- how far and how **adequately the management is discharging its function** in so far as correct **recording of transactions** is concerned;
- how **reliable** the **reports, records** and the **certificates** to the management can be;
- the **extent** and the **depth** of the **examination** that he needs to carry out in the different areas of accounting;
- what would be **appropriate audit technique** and the **audit procedure** in the given circumstances;
- what are the areas where **control is weak** and **where it is excessive**; and
- whether some worthwhile **suggestions** can be given to improve the control system.

Part II: Correct/Incorrect Questions

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| Q1. | Maintenance of Internal Control System is the responsibility of the Statutory Auditor. (ICAI Study Material - Test Your Knowledge) |
| | 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 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. |
| Q2. | Satisfactory Control environment is not an absolute deterrent to fraud. (SA, May 2019, 2 Marks) |
| | Correct. The existence of a Satisfactory Control environment can be a positive factor when an auditor assesses the risk of material misstatement. However, although it may help reduce the risk of fraud , a satisfactory Control environment is not an absolute deterrent to fraud . |
| Q3. | Satisfactory Control environment is an absolute deterrent to fraud. (MTP1, Nov 2021, 2 Marks) |
| | Incorrect. The existence of a Satisfactory Control environment can be a positive factor when an auditor assesses the risk of material misstatement. However, although it may help reduce the risk of fraud , a satisfactory Control environment is not an absolute deterrent to fraud . |
| Q4. | Internal control cannot eliminate risk of material misstatements in the financial statements. (SA, Dec 2021, 2 marks) |
| | 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 a possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist. |
| Q5. | Control environment can prevent, detect and correct a material misstatement. (MTP2, May 2022, 2 marks) (RTP, May 2023, NA) (RTP, Nov 2023, NA) |
| | Incorrect. The control environment in itself does not prevent, or detect and correct, a material misstatement . It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement |
| Q6. | Inappropriate management can override internal controls of any organization. (SA, May 2022, 2 Marks) |
| | 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 |

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| | 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. |
| Q7. | The internal control questionnaire is a series of instructions/ questions which a member of the auditing staff must follow and/or answer. (MTP2, Nov 2022, 2 Marks) |
| | Incorrect. Check list is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. Internal control questionnaire is a comprehensive series of questions concerning internal control. The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. |
| Q8. | Narrative record is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer (MTP1, May 2023, 2 marks) |
| | Incorrect. Check list is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. Narrative record is a complete and exhaustive description of the system as found in operation by the auditor. |

Part III: Multiple Choice Questions

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| Q1. | <p>The management of Magoo Ltd. has developed a strong internal control in its accounting system in such a way that the work of one person is reviewed by another. Since no individual employee is allowed to handle a task alone from the beginning to the end, the chances of early detection of frauds and errors are high. CA. Olive has been appointed as an auditor of the company for current Financial Year 2023-24. Before starting the audit, she wants to evaluate the internal control system of Magoo Ltd. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, CA. Olive decided to use internal control questionnaire to know and assimilate the system and evaluate the same. Which of the following questions need not be framed under internal control questionnaire relating to purchases?</p> <p>(a) Are authorized signatories for purchases limited to elected officials? (b) Are payments approved only on original invoices? (c) Does authorized officials thoroughly review the documents before signing cheques? (d) Are monthly bank reconciliations implemented for each and every bank accounts of the company?</p> <p>(Sample MCQS)(RTP, May 2019, NA)</p> |
| | Correct answer: (d) Are monthly bank reconciliations implemented for each and every bank accounts of the company? |
| Q2. | <p>A company is engaged in manufacturing of wooden furniture. The auditor of company notes that company has identified emerging risks pertaining to probable reduction in demand of company's products due to procurement of imported furniture from South East Asian nations. It has also estimated how significant are those risks and their possibility of happening. Besides, it has also formulated an action plan to deal with the situation, in case these risks materialize. Which of the following options would be most appropriate to describe above situation?</p> <p>(a) An example of audit risk for auditor (b) An example of component of internal control of company (c) An example of control risk of company (d) An example of inherent risk for auditor</p> <p>(MTP2, Nov 2022, 1 Mark)</p> |
| | <p>Correct answer: (b) An example of component of internal control of company</p> <p>Explanation:</p> <ul style="list-style-type: none"> • The given case explains "The entity's risk assessment process", one of the components of the internal control of the entity. • Regarding entity's risk assessment process, the auditor shall obtain an understanding of whether the entity has a process for: (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks. |
| Q3. | To evaluate the Internal Control of Kingsway Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the |

auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

- (a) Narrative record
- (b) Check List
- (c) Internal Control questionnaire
- (d) Flow chart

(MTP1, Nov 2023, 1 mark)

Correct answer: (c) Internal Control questionnaire

Explanation:

- Internal Control Questionnaire is a comprehensive series of questions concerning internal control. The auditor sends a questionnaire to the client for completion by relevant staff; any inconsistencies found are clarified through discussion, leading to a report on deficiencies and improvement recommendations.
- **The difference between check list and Questionnaire:** Both include a detailed series of instructions generally in Yes/No form. However, in the checklist junior or article assistant is required to ask questions from the client and fill the response and a questionnaire is usually issued to the client and the client is requested to get it filled by their employees.

Chapter 3B - Response to the Assessed Risk

Part I : Descriptive Questions

Testing of Internal Control

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| Q1. | <p>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. (ICAI Study Material - Test Your Understanding)</p> |
| | <ul style="list-style-type: none"> • 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" |
| Q2. | <p>XYZ & Associates, Chartered Accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences. (SA, May 2018, 5 Marks) (MTP1, May 2021, 4 Marks)</p> <p>Evaluating the Operating Effectiveness of Controls:</p> <p>When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.</p> <p>When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:</p> <ul style="list-style-type: none"> • The tests of controls that have been performed provide an appropriate basis for reliance on the controls; • Additional tests of controls are necessary; or • The potential risks of misstatement need to be addressed using substantive procedures. <p>A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control</p> |
| Q3. | <p>A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. (RTP, Nov 2018, NA) (RTP, Nov 2020, NA)</p> <p>Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.</p> <p>The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:</p> <ul style="list-style-type: none"> • He expects that the controls are operating effectively, or • Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. <p>A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.</p> |
| Q4. | <p>Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting. (SA, Nov 2019, 4 Marks) (MTP2, May 2023, 4 marks)</p> |

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| | <p>In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:</p> <ul style="list-style-type: none"> • The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process; • The risks arising from the characteristics of the control, including whether it is manual or automated; • The effectiveness of general IT-controls; • The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control; • Whether the lack of a change in a particular control poses a risk due to changing circumstances; and • The risks of material misstatement and the extent of reliance on the control |
| Q5. | <p>When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls. (RTP, Nov 2020, NA)</p> <p>When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:</p> <ul style="list-style-type: none"> • The frequency of the performance of the control by the entity during the period. • The length of time during the audit period that the auditor is relying on the operating effectiveness of the control. • The expected rate of deviation from a control. • The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level. • The extent to which audit evidence is obtained from tests of other controls related to the assertion |

Tests of Details

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| Q6. | <p>Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. Analyse and explain. (RTP, Nov 2018, NA)</p> <p style="text-align: center;">OR</p> <p>"A multinational co. wants to appoint you to carry the statutory audit." Discuss with reference to SA 330 the substantive procedures to be performed to assess the risk of material misstatement. (SA, Nov 2018, 6 Marks)</p> <p>Substantive procedures to be performed to assess the risk of material misstatement:</p> <ul style="list-style-type: none"> • Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. • Depending on the circumstances, the auditor may determine that: <ul style="list-style-type: none"> ○ Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls. ○ Only tests of details are appropriate. ○ A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks. • Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. • The nature of the risk and assertion is relevant to the design of tests of details. <ul style="list-style-type: none"> ○ For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. ○ On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included. • Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. |
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- In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

Internal Financial Controls as per Regulatory Requirements

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| Q7. | <p>Explain the meaning of internal financial controls as per the Companies Act, 2013. Also explain its objectives. (MTP2, Nov 2021, 4 Marks)</p> |
| | <p>Section 134(5)(e) explains the meaning of internal financial controls as, “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”</p> <p>From the above definition, it is clear that internal financial controls are the policies and procedures adopted by the company for:</p> <ul style="list-style-type: none"> • ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, • the safeguarding of its assets, • the prevention and detection of frauds and errors, • the accuracy and completeness of the accounting records, and • the timely preparation of reliable financial information. |
| Q8. | <p>Explain the meaning of Internal Financial Controls clearly stating reporting requirement (with reference to audit) on adequacy of internal financial controls. Also discuss about its (reporting requirement on adequacy of internal financial controls) applicability on various types of Companies. (RTP, May 2022, NA)</p> |
| | <p>Section 134(5)(e) explains the meaning of internal financial controls as, “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”</p> <p>Section 143(3)(i) of the Companies Act 2013 requires an auditor to report whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls.</p> <p>However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–</p> <ul style="list-style-type: none"> • One person company; or Small company; or • Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than ₹ 25 crore. |

Part II: Correct/Incorrect Questions

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| Q1. | <p>Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems. (ICAI Study Material - Test Your Knowledge)</p> |
| | <p>Correct. Tests of Control are performed to obtain audit evidence about the effectiveness of:</p> <ul style="list-style-type: none"> • 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 • the operation of the internal controls throughout the period. |
| Q2. | <p>Inquiry alone is sufficient to test the operating effectiveness of controls. (ICAI Study Material - Test Your Knowledge) (SA, May 2018, 2 Marks)</p> |
| | <p>Incorrect. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry.</p> |

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| | Inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made. |
| Q3. | When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall not perform substantive procedures that are specifically responsive to that risk. (RTP, Nov 2018, NA) (RTP, May 2019, NA) |
| | Incorrect. When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details . |
| Q4. | 'Test of Control' may be defined as an audit procedure designed to detect material misstatements at the assertion level. (MTP1, Nov 2019, 2 Marks) |
| | Incorrect. Substantive procedure may be defined as an audit procedure designed to detect material misstatements at the assertion level whereas 'tests of controls' is an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting , material misstatements at the assertion level. |
| Q5. | The auditor's reporting on internal financial control will be applicable with respect to interim financial statements. (SA, Nov 2019, 2 marks) (MTP2, May 2023, 2 marks) |
| | Incorrect. Section 143(3)(i) of the Companies Act 2013 requires the auditors' report to state whether the company has adequate internal financial controls with reference to FS in place and the operating effectiveness of such controls. It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143. Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements , such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation. |

Part III: Multiple Choice Questions

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| Q1. | Who is responsible for maintaining effective internal financial controls? (a) Statutory auditor (b) Audit Committee (c) Management (d) Shareholders (ICAI Study Material - Test Your Knowledge) |
| | Correct answer: (c) Management Explanation: The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls |
| Q2. | Because the assessment of the risk of material misstatement takes account of internal control, (a) the extent of substantive procedures may need to be increased irrespective of the results from tests of controls. (b) the extent of substantive procedures may need to be increased when the results from tests of controls are satisfactory. (c) the extent of substantive procedures may need to be decreased when the results from tests of controls are unsatisfactory. (d) the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. (Sample MCQs) (ICAI MCQs) |
| | Correct answer: (d) the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory |
| Q3. | When deviations from controls upon which the auditor intends to rely are detected, |

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| | <p>(a) the auditor shall not make any inquiries to understand these matters and their potential consequences</p> <p>(b) the auditor shall make specific inquiries to understand these matters and their potential consequences</p> <p>(c) the auditor shall make general inquiries to understand these matters and their potential consequences</p> <p>(d) the auditor shall make both general as well as specific inquiries to understand these matters and their potential consequences</p> <p>(Sample MCQs) (ICAI MCQs) (RTP, Nov 2019, NA)</p> |
| | <p>Correct answer: (b) the auditor shall make specific inquiries to understand these matters and their potential consequences</p> |
| Q4. | <p>When more persuasive audit evidence is needed regarding the effectiveness of a control,</p> <p>(a) it may be appropriate to increase the extent of testing of the control and reduce the extent of the degree of reliance on controls</p> <p>(b) it may be appropriate to decrease the extent of testing of the control as well as the degree of reliance on controls.</p> <p>(c) it may be appropriate to decrease the extent of testing of the control and increase the extent of the degree of reliance on controls.</p> <p>(d) it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls.</p> <p>(Sample MCQs) (RTP, Nov 2019, NA)</p> |
| | <p>Correct answer: (d) it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls</p> |
| Q5. | <p>Who is mainly responsible for implementation of internal financial controls in a company?</p> <p>(a) Auditors</p> <p>(b) Directors</p> <p>(c) Employees</p> <p>(d) Regulators</p> <p>(ICAI MCQs)</p> |
| | <p>Correct answer: (b) Directors</p> <p>Explanation: The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls</p> |
| Q6. | <p>The Guidance Note on Audit of Internal Financial Controls over Financial Reporting has been issued by?</p> <p>(a) ICAI</p> <p>(b) SEBI</p> <p>(c) MCA</p> <p>(d) RBI</p> <p>(ICAI MCQs) (MTP1, May 2019, 1 Mark)</p> |
| | <p>Correct answer: (a) ICAI</p> |
| Q7. | <p>Who among the following is required to comply with Section 149(8) read with Schedule IV to the companies Act,2013?</p> <p>(a) Board of Directors</p> <p>(b) Audit Committee</p> <p>(c) Statutory Auditor</p> <p>(d) Independent Directors</p> <p>(ICAI MCQs)</p> |
| | <p>Correct answer: (d) Independent Directors</p> <p>Explanation: As per Section 149(8) of the Act, the company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for Independent Directors. As per this code, the role and functions of Independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible</p> |

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| Q8. | <p>The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:</p> <p>(a) reliability of financial reporting (b) effectiveness and efficiency of operations (c) compliance with applicable laws and regulations (d) All of the above</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (d) All of the above</p> | |
| Q9. | <p>The company and _____ shall abide by the provisions specified in Schedule IV which lays down the Code for Independent Directors</p> <p>(a) independent directors (b) women directors (c) board of directors (d) executive directors</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (a) independent directors</p> <p>Explanation: As per Section 149(8) of the Act, the company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for Independent Directors. As per this code, the role and functions of Independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible</p> | |
| Q10. | <p>In designing and performing test of controls, the auditor shall perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:</p> <p>(i) How the controls were applied at relevant times during the period under audit. (ii) The consistency with which they were applied. (iii) By whom or by what means they were applied.</p> <p>Which of the following is correct?</p> <p>(a) (i) and (ii) (b) (ii) and (iii) (c) (i),(ii) and (iii) (d) (i) and (iii)</p> <p>(ICAI MCQs) (MTP1, May 2022, 1 mark)</p> |
| <p>Correct answer: (c) (i),(ii) and (iii)</p> | |
| Q11. | <p>Statement 1: Audit procedures consist of Risk Assessments Procedures and other procedures. Statement 2: Substantive procedures consist of test of details and analytical procedures.</p> <p>(a) Only Statement 1 is correct (b) Only Statement 2 is correct (c) Both 1 & 2 are correct (d) Both 1 & 2 are incorrect</p> <p>(RTP, May 2020, NA) (MTP1, Nov 2022, 1 Mark)</p> |
| <p>Correct answer: (c) Both 1 & 2 are correct</p> | |
| Q12. | <p>The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:</p> <p>(i) Reliability of financial reporting (ii) Compliance with applicable laws and regulations (iii) Safeguarding of assets. (iv) Effectiveness and efficiency of operations (v) Prevention and detection of frauds</p> |

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| | <p>Which statement is correct?</p> <p>(a) (i),(ii)and (iv) (b) (i),(iii) (v) and(ii) (c) (i),(ii),(iii) and (iv) (d) (i), (ii),(iii),(iv)and (v)</p> <p>(MTP1, Nov 2023, 1 mark)</p> |
| | <p>Correct answer: (d) (i), (ii),(iii),(iv)and (v)</p> <p>Explanation: The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring: Reliability of financial reporting, Effectiveness and efficiency of operations, Compliance with applicable laws and regulations, Safeguarding of assets, Prevention and detection of frauds</p> |
| Q13. | <p>Financial statements of a company have been put up for audit before the auditor. On going through financial statements, he wants 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. As regards verification of bills debited in "Machinery repair" account, identify what he intends to perform?</p> <p>(a) Tests of Controls (b) Tests of transactions (c) Tests of balances (d) Risk assessment procedures</p> <p>(MTP1, Nov 2023, 1 mark)</p> |
| | <p>Correct answer: (b) Tests of transactions</p> <p>Explanation: Tests of details are further classified into tests of transactions i.e., vouching and tests of balances i.e., verification. For example, a purchase transaction may be verified by examining the related purchase invoice, goods received note, inward gate entry register. Such tests of transactions help in establishing the authenticity of transactions recorded in books of accounts</p> |

Chapter 3C - Materiality

Part I : Descriptive Questions

What is meant by materiality?

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| Q1. | <p>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 (ICAI Study Material - Test Your Understanding)</p> |
| | <p>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</p> |
| Q2. | <p>One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor (ICAI Study Material - Illustration)</p> |
| | <p>The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.</p> |
| Q3. | <p>Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain (RTP, May 2021, NA)</p> |
| | <p>Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:</p> <ol style="list-style-type: none"> 1. Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements; 2. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and 3. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered. |
| Q4. | <p>What could be considered material for all situations cannot be defined precisely and an amount or transaction material in one situation may not be material in other situation. Explain. (RTP, Nov 2021, NA)</p> |
| | <ul style="list-style-type: none"> ● SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially misstated. ● The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. ● It may be noted that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures. At the planning stage, the auditor needs to consider the materiality for the financial statements as a whole. The auditor has to carry out a preliminary identification of significant components and material classes of transactions, account balances and disclosure which he plans to examine. ● What could be considered material for all situations cannot be defined precisely and an amount or transaction material in one situation may not be material in other situation. For example, ₹ 5,000 may be material for a small entity, but even ₹ 100,000 may not be material for a large entity |
| Q5. | <p>While conducting the audit of Smart TV Ltd, engagement team of HTR & Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk. (RTP, May 2022, NA)</p> |

Audit risk is the risk that the auditor expresses an **inappropriate** audit **opinion** when the financial statements are **materially misstated**. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

- **Identifying** and **assessing** the **risks** of material misstatement;
- Determining the nature, timing and extent of **further audit procedures**; and
- Evaluating the effect of **uncorrected misstatements**, if any, on the financial statements and in forming the opinion in the auditor's report.

Determination of materiality- a matter of professional judgment

Q6. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, explain the auditor's assumptions about users of the financial statements. **(RTP, May 2021, NA)**

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

- Have a **reasonable knowledge** of **business** and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- **Understand** that financial statements are **prepared, presented** and **audited to levels of materiality**;
- Recognize the **uncertainties** inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make **reasonable economic decisions** on the basis of the information in the financial statements.

Benchmarking

Q7. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Discuss stating the factors that may affect the identification of an appropriate benchmark **(RTP, May 2018, NA)**

OR

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.

(SA, Nov 2020, 4 Marks)

OR

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

(RTP, May 2022, NA)

OR

An auditor has to exercise professional judgement in determining materiality. Explain the factors that may affect the identification of an appropriate benchmark in determining materiality for the financial statements as whole.

(SA, May 2023, 3 marks)

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

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

Revision of Materiality

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| Q8. | Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. (MTP1, Nov 2019, 3 Marks) |
| | <p>Revision in Materiality level as the Audit Progresses:</p> <ul style="list-style-type: none"> ● Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a <ul style="list-style-type: none"> ○ change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), ○ new information, or ○ change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. ● If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality. ● If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate. |

Documenting the Materiality

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| Q9. | Is materiality required to be documented by the auditor? What factors have to be considered this regard? (ICAI Study Material - Test Your Knowledge) |
| | <p>The audit documentation shall include the following amounts and the factors considered in their determination:</p> <ol style="list-style-type: none"> 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 |

Part II: Correct/Incorrect Questions

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| Q1. | There is a direct relationship between materiality and the degree of audit risk. (ICAI Study Material - Test Your Knowledge) (RTP, May 2018, NA) |
| | 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. |
| Q2. | Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular class of transactions, account balances or disclosures) does not need any revision. (MTP2, May 2018, 2 Marks) |
| | Incorrect. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of <ul style="list-style-type: none"> ● a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), ● new information, or ● a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures |
| Q3. | Determining materiality involves the exercise of professional judgement. (SA, Jan 2021, 2 Marks) |
| | Correct. Determining materiality involves the exercise of professional judgment . A percentage is often applied to a chosen |

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| | benchmark as a starting point in determining materiality for the financial statements as a whole. |
| Q4. | When establishing the overall audit strategy, the auditor need not determine materiality for the financial statements as a whole. (RTP, May 2021, NA) |
| | Incorrect. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. |
| Q5. | The concept of materiality is an important and relevant consideration for the auditor in financial statement. (MTP1, Nov 2021, 2 Marks) (MTP1, Nov 2022, 2 Marks) |
| | Correct. The concept of materiality is fundamental to the process of accounting . It covers all the stages from recording to classification and presentation. It is very important for the auditor who has to constantly judge whether a particular item is material or not and ensure that a material item is disclosed separately and distinctly. |
| Q6. | When profit before tax from continuing operations is non-volatile, other benchmarks will be appropriate (SA, Dec 2021, 2 marks) |
| | Incorrect. Profit before tax from continuing operations is often used for profit-oriented entities . When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate , such as gross profit or total revenues . |
| Q7. | Materiality is not a matter of size. (SA, May 2022, 2 Marks) (MTP2, May 2023, 2 marks) |
| | 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. |
| Q8. | If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality. (MTP2, Nov 2022, 2 Marks) |
| | Correct. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit, new information , or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. |
| Q9. | 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. (SA, Nov 2022, 2 marks) |
| | 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% shares specifying the number of shares held" in notes to accounts |

Part III: Multiple Choice Questions

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| Q1. | 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. (ICAI Study Material - Test Your Knowledge) |
| | Correct answer: (d) It is not always a matter of relative size. Explanation: |

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| | <ul style="list-style-type: none"> • If there is any statutory requirement of disclosure, it is to be considered material irrespective of the value of amount. Hence, it is affected by requirements of law or regulations. It is also affected by the nature of an item. • The auditor's determination of materiality is a matter of professional judgment. • 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. |
| Q2. | <p>SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor</p> <p>(a) should not consider materiality and its relationship with audit risk while conducting an audit. (b) should consider materiality and its relationship with audit risk while conducting an audit. (c) should not consider materiality but should consider its relationship with audit risk while conducting an audit. (d) should consider materiality but need not consider its relationship with audit risk while conducting an audit.</p> <p>(Sample MCQs) (ICAI MCQs) (MTP1, May 2019, 1 Mark) (MTP1, May 2021, 2 Marks)</p> |
| | <p>Correct answer: (b) should consider materiality and its relationship with audit risk while conducting an audit. Explanation: Materiality and audit risk are considered throughout the audit, in particular, when identifying and assessing ROMM, determining NTE of further audit procedures; and evaluating the effect of uncorrected misstatements, if any, on the FS and in forming the opinion in the auditor's report</p> |
| Q3. | <p>Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of _____</p> <p>(a) Independence (b) Professional Judgment (c) Professional skepticism (d) All of the above</p> <p>(Sample MCQs)(ICAI MCQs) (MTP2, May 2019, 1 Mark)</p> |
| | <p>Correct answer: (b) Professional Judgment Explanation: Determining materiality involves the exercise of professional judgment</p> |
| Q4. | <p>Which of the following is not an example of benchmarks in determining materiality for the Financial Statements as whole:</p> <p>(a) Profit before tax (b) total revenue (c) audit programme (d) total equity</p> <p>(ICAI MCQs)</p> |
| | <p>Correct answer: (c) audit programme Explanation: Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.</p> |
| Q5. | <p>The concept of materiality is applied by the auditor :</p> <p>(a) in planning and performing the audit (b) in evaluating the effect of identified misstatements on the audit (c) both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit (d) none of the above is correct</p> <p>(MTP1, Nov 2020, 2 Marks) (RTP, May 2021 NA) (MTP1, Nov 2022, 1 Mark)</p> |
| | <p>Correct answer: (c) both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit Explanation: The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report</p> |

Chapter 3D - Automated Environment

Part I : Descriptive Questions

Meaning and Key features of an Automated Environment

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| Q1. | <p>Explain the meaning of an automated environment. Also discuss the key features of an automated environment. (RTP, May 2019, NA)</p> <p style="text-align: center;">OR</p> <p>The fundamental principle of an automated environment is the ability to carry out business with less manual intervention. Explain. (MTP1, May 2019, 3 marks)</p> |
| | <p>Meaning and Features of an Automated Environment</p> <ul style="list-style-type: none"> ● An automated environment refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. ● The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. ● The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex. ● For example, if a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment. <p>Key features of an automated environment are as follows:</p> <ul style="list-style-type: none"> ● Faster business operations ● Accuracy in data processing and computation ● Ability to process large volumes of transactions ● Integration between business operations ● Better security and controls ● Less prone to human errors ● Provides latest information ● Connectivity and Networking capability |

Understanding and documenting automated environment

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| Q2. | <p>Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls. Explain stating the points that an auditor should consider to obtain an understanding of the company's automated environment. (RTP, May 2018, NA) (MTP1, Nov 2019, 4 marks) (MTP1, Nov 2023, 3 marks)</p> <p style="text-align: center;">OR</p> <p>In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls. Advise some of the points that an auditor should consider to obtain an understanding of the company's automated environment (MTP2, May 2018, 5 Marks)</p> <p style="text-align: center;">OR</p> <p>Explain some of the points that an auditor should consider to obtain an understanding of the company's automated environment. (SA, May 2018, 5 Marks) (RTP, Nov 2019, NA) (MTP1, Nov 2021, 4 marks) (MTP1, May 2022, 4 Marks) (RTP, Nov 2022, NA) (RTP, Nov 2023, NA)</p> |
| | <p>Understanding and Documenting Automated Environment:</p> <p>In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.</p> |

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| | <p>Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment</p> <ul style="list-style-type: none"> ● Information systems being used (one or more application systems and what they are) ● their purpose (financial and non-financial) ● Location of IT systems - local vs global ● Architecture (desktop based, client-server, web application, cloud based) ● Version (functions and risks could vary in different versions of same application) ● Interfaces within systems (in case multiple systems exist) ● In-house vs Packaged ● Outsourced activities (IT maintenance and support) ● Key persons (CIO, CISO, Administrators) <p>The understanding of a company's IT environment that is obtained should be documented</p> |
| Q3. | <p>When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement? (SA, May 2022, 3 Marks)</p> <p>Statement given is incorrect. When the company is working in an automated environment, it is necessary for its auditor to understand its automated environment</p> <p>Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment</p> <ul style="list-style-type: none"> ● Information systems being used (one or more application systems and what they are) ● their purpose (financial and non-financial) ● Location of IT systems - local vs global ● Architecture (desktop based, client-server, web application, cloud based) ● Version (functions and risks could vary in different versions of same application) ● Interfaces within systems (in case multiple systems exist) ● In-house vs Packaged ● Outsourced activities (IT maintenance and support) ● Key persons (CIO, CISO, Administrators) |

Understanding the Risks that arise from the use of IT and IT Systems

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| Q4. | <p>The auditor should understand and consider the risks that may arise from the use of Information Technology (IT) Systems. (SA, May 2018, 5 Marks)</p> <p style="text-align: center;">OR</p> <p>Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should consider the risks that arise from the use of IT systems. Explain. (MTP1, Nov 2018, 5 Marks) (RTP, Nov 2019, NA)</p> <p style="text-align: center;">OR</p> <p>Which are specific risks to the company's internal control having IT environment? (SA, May 2019, 4 Marks) (RTP, Nov 2022, NA)</p> <p>Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. Given below are some such risks that should be considered,</p> <ul style="list-style-type: none"> ● Inaccurate processing of data, processing inaccurate data, or both ● Unauthorized access to data ● Direct data changes (backend changes) ● Excessive access / Privileged access (super users) ● Lack of adequate segregation of duties ● Unauthorized changes to systems or programs ● Failure to make necessary changes to systems or programs ● Loss of data |
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| Q5. | <p>Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting (RTP, May 2018, NA)</p> <p style="text-align: center;">OR</p> <p>Describe how risks in the IT system if not mitigated could have an impact on the audit. (SA, Nov 2020, 3 marks) (RTP, Nov 2021, NA) (MTP2, Nov 2021, 3 marks) (MTP1, Nov 2022, 3 Marks) (MTP1, May 2023, 3 marks)</p> <hr/> <p>Impact of IT related risks:</p> <p>Impact on substantive checking The auditor may not be able to rely on the reports, data obtained from systems where such risk exists. This means all forms of data, information or reports that the auditor obtains from the system for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy. It could lead to increased substantive checking i.e., detailed checking.</p> <p>Impact on controls It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.</p> <p>Impact on reporting Due to regulatory requirements in respect of internal financial controls in case of companies, it may lead to modification of auditor's report in some instances</p> |
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Types of Controls in an Automated Environment

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| Q6. | <p>Discuss relationship between "General IT controls" and "application controls" in an automated environment. (ICAI Study Material - Test Your Knowledge)</p> <hr/> <p>General IT Controls vs. Application Controls:</p> <ul style="list-style-type: none"> • 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. |
| Q7. | <p>Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Discuss the activities performed by Data Center and Network operations. Also explain the meaning of General IT Controls in detail. (RTP, May 2021, NA)</p> <hr/> <p>General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:</p> <ol style="list-style-type: none"> i) Data center and network operations ii) Program change iii) Access security iv) Application system acquisition, development, and maintenance (Business Applications) <p>These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.</p> <p>Data Center and Network Operations Objective: To ensure that production systems are processed to meet financial reporting objectives</p> <p>Activities:</p> <ul style="list-style-type: none"> • overall management of computer operation activities, • preparing, scheduling and executing of batch jobs, • monitoring, storage and retention of backups. • Such controls also help in performance monitoring of operating system, database and networks. |

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| | <ul style="list-style-type: none"> Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls |
| Q8. | <p>Explain the objective and enlist the activities involved in the General IT Controls over "Program Change" (MTP2, Nov 2022, 3 Marks)</p> <p>Program Change Objective: To ensure that modified systems continue to meet financial reporting objectives.</p> <p>Activities:</p> <ul style="list-style-type: none"> change management process, recording, managing and tracking change requests, making and testing changes |
| Q9. | <p>In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. One such area is access security. What is the objective of access security and what are the activities included in it? (SA, Nov 2022, 3 marks)</p> <p>Access Security in Automated Environment: Objective of access security: The objective of Access Security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.</p> <p>Activities:</p> <ul style="list-style-type: none"> security organization & management, security policies & procedures, application security, data security, operating system security, network security, physical security |

Testing methods

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| Q10. | <p>Discuss the different ways testing is performed in an automated environment (MTP1, May 2018, 5 Marks)</p> <p style="text-align: center;">OR</p> <p>Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement. Discuss stating the different ways testing is performed in an automated environment. (MTP2, Nov 2018, 5 Marks)</p> <p>The following are different ways testing is performed in an automated environment :</p> <p>There are basically four types of audit tests that should be used- inquiry, observation, inspection and reperformance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.</p> <p>Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.</p> <p>Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence.</p> <p>Which audit test to use, when and in what combination is a matter of professional judgment and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc.</p> |
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| | <p>The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.</p> <p>When testing in an automated environment, some of the more common methods are as follows:</p> <ul style="list-style-type: none"> • Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection. • Observe how a user processes transactions under different scenarios. • Inspect the configuration defined in an application |
| Q11. | <p>Explain some of the commonly used methods for testing in an automated environment.(RTP, May 2020, NA)</p> <p style="text-align: center;">OR</p> <p>Discuss the common methods applied by the auditor when testing in an automated environment is done by him (SA, Jan 2021, 4 marks)</p> <p>When testing in an automated environment, some of the more common methods are as follows:</p> <ul style="list-style-type: none"> • Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection. • Observe how a user processes transactions under different scenarios. • Inspect the configuration defined in an application. |

Audit Approach in an Automated Environment

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| Q12. | <p>The directors and management have primary responsibility of implementing and maintaining an effective internal controls framework and auditors are expected to evaluate, validate and report on the design and operating effectiveness of internal financial controls. Explain the framework which helps the auditors in fulfilling this responsibility (Old ICAI Study Material)</p> <p>The Guidance note on Audit of Internal Financial Controls over Financial Reporting issued by the Institute of Chartered Accountants of India provides a framework that auditors should follow to fulfill their responsibility. The below is a summary of this controls based audit approach :-</p> <ul style="list-style-type: none"> • Risk Assessment <ul style="list-style-type: none"> ○ Identify significant accounts and disclosures ○ Qualitative and Quantitative considerations ○ Relevant Financial Statement Assertions ○ Identify likely sources of misstatement ○ Consider risk arising from use of IT systems • Understand and Evaluate <ul style="list-style-type: none"> ○ Document understanding of business processes using Flowcharts/ Narratives ○ Prepare Risk and Control Matrices (RCM) ○ Understand design of controls by performing walkthroughs of end-to-end process ○ Process wide considerations for Entity Level Controls, Segregation of Duties ○ IT General Controls, Application Controls • Test for Operating Effectiveness <ul style="list-style-type: none"> ○ Assess NTE of controls testing ○ Assess reliability of source data; completeness of population ○ Testing of key reports and spreadsheets ○ Sample testing ○ Consider competence and independence of staff/team performing controls testing • Reporting <ul style="list-style-type: none"> ○ Evaluate Control Deficiencies ○ Significant deficiencies, Material Weaknesses ○ Remediation of control weaknesses ○ Internal Controls Memo (ICM) or Management Letter |
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- Auditor's report

Data Analytics

- Q13. A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company (**ICAI Study Material - Test Your Knowledge**)
- OR**
- In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. Explain stating uses of Data analytics. (**RTP, Nov 2018, NA**) (**MTP2, May 2019, 4 marks**)
- OR**
- While it is true that companies can benefit immensely from the use of data analysis in terms of increased profitability, better customer service, etc., analyse various functions that can be performed even by the auditor also using Data Analytics tools and techniques in the audit process to obtain good results (**SA, Nov 2020, 4 marks**) (**MTP1, Nov 2023, 3 marks**)
- OR**
- 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 check completeness of data and population that is used in either test of controls or substantive audit tests. Explain in detail stating all the relevant points. (**RTP, May 2020, NA**)
- OR**
- Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform Fraud investigation. Explain the other relevant points in the above context i.e. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform. (**MTP1, Nov 2020, 4 marks**)
- OR**
- Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the selection of audit samples. Explain giving other relevant points also in the above context of data analytics (**RTP, May 2021, NA**)
- OR**
- While auditing in an automated environment how data analytics can be used in testing electronic records and data residing in IT systems using spread sheets and specialised audit tools? (**SA, May 2023, 3 marks**)
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- In today's digital age when companies rely more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil".
- Data analytics is the **combination** of **processes, tools** and **techniques** that are used to **tap vast amounts** of electronic **data** to **obtain meaningful information**. The companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results.
- The tools and techniques that auditors use in applying the principles of data analytics are known as **Computer Assisted Auditing Techniques** (CAATs)
- Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialized audit tools viz., IDEA and ACL to perform the following,
- check **completeness** of data and population that is used in either test of controls or substantive audit tests
 - **selection** of audit **samples** – random sampling, systematic sampling
 - **re-computation** of balances – reconstruction of trial balance from transaction data
 - **reperformance** of mathematical calculations – depreciation, bank interest calculation.
 - **analysis** of **journal entries** as required by SA 240
 - **fraud** investigation
 - evaluating impact of **control deficiencies**

Assess and Report Audit Findings

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| Q14. | <p>Forceful Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2023-24, 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 (SA, July 2021, 3 marks) (MTP2, May 2023, 3 marks)</p> <p style="text-align: center;">OR</p> <p>The Auditor of HK Limited completed the audit of the company in an automated environment. Management of the company requested the auditor to give an idea about any exceptions observed in IT environment that need to be assessed. How the auditor should consider this request and report in light of an audit perspective? (SA, May 2022, 3 Marks)</p> |
| | <p>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.</p> <p>Some points to consider are as follows:</p> <ul style="list-style-type: none"> • Are there any weaknesses in IT controls? • What is the impact of these weaknesses on overall audit? • Report deficiencies to management – Internal Controls Memo or Management Letter. • Communicate in writing any significant deficiencies to Those Charged With Governance. <p>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.</p> |

Part II: Correct/Incorrect Questions

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| Q1. | <p>The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. (MTP1, May 2018, 2 Marks) (MTP2, Nov 2018, 2 marks) (MTP1, May 2019, 2 marks)</p> <p>Correct. The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.</p> |
| Q2. | <p>Application controls include manual controls only that operate at a business process level. (MTP1, May 2018, 2 Marks) (MTP1, Nov 2018, 2 marks) (MTP2, Nov 2018, 2 marks)</p> <p>Incorrect. Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.</p> |
| Q3. | <p>Evaluation and assessment of audit findings and control deficiencies does not involve application of professional judgment. (MTP2, May 2018, 2 marks)</p> <p style="text-align: center;">OR</p> <p>Audit findings and control deficiencies can be evaluated or assessed arbitrarily. (SA, May 2022, 2 marks)</p> <p>Incorrect. Evaluation and assessment of audit findings and control deficiencies involves applying professional judgment 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.</p> |
| Q4. | <p>When auditing in an automated environment, inquiry is often the most efficient and effective audit testing method. (SA, Nov 2018, 2 Marks) (MTP1, Nov 2021, 2 marks) (MTP2, Nov 2021, 2 marks)</p> <p>Incorrect. There are basically four types of audit tests that should be used in an automated environment. They are inquiry, observation, inspection and re-performance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.</p> |

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| Q5. | The Complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be less complex. (SA, Jan 2021, 2 marks) (MTP2, May 2023, 2 marks) |
| | <p>Incorrect. The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.</p> <p>If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.</p> |
| Q6. | 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. (SA, July 2021, 2 marks) (MTP1, Nov 2023, 2 marks) |
| | <p>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.</p> |
| Q7. | All automated environments are not complex. (MTP2, Nov 2021, 2 marks) (MTP1, May 2022, 2 Marks) |
| | <p>Correct. The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be an environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.</p> |
| Q8. | A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as meaningful data. (MTP2, Nov 2021, 2 marks) (MTP1, May 2022, 2 Marks) |
| | <p>Incorrect. A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as Data Analytics.</p> |
| Q9. | In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated. (SA, Nov 2022, 2 marks) |
| | <p>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.</p> |
| Q10. | If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered less complex and easy to audit compared to using an off-the-shelf accounting software. (SA, May 2023, 2 marks) |
| | <p>Incorrect. If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using off-the-shelf accounting software, then it is likely to be less automated, less complex and easy to audit.</p> |

Part III: Multiple Choice Questions

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| Q1. | <p>The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?</p> <p>(a) It results in complex business environment.</p> <p>(b) It results in simple business environment and easier audit.</p> <p>(c) Automation has no relationship with complexity of business environment.</p> <p>(d) It results in simple business environment. However, it increases complexity of audit.</p> <p>(ICAI Study Material - Test Your Knowledge)</p> |
| | <p>Correct answer: (a) It results in complex business environment.</p> <p>Explanation: The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex</p> |

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| Q2. | <p>Which of the following is not a risk to a company's internal control due to its IT environment?</p> <p>(a) Potential loss of data (b) Inability to access data when required (c) Unauthorized access to data (d) Processing of large volumes of data</p> <p>(ICAI Study Material - Test Your Knowledge)</p> |
| | <p>Correct answer: (d) Processing of large volumes of data Explanation: Risks arising from use of IT Systems are Inaccurate processing of data, processing inaccurate data, or both, Unauthorized access to data, Direct data changes, Excessive access / Privileged access, Lack of adequate SOD, Unauthorized changes to systems or programs, Failure to make necessary changes to systems or programs, Loss of data</p> |
| Q3. | <p>Which of the following is not an example of "General IT controls"?</p> <p>(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</p> <p>(ICAI Study Material - Test Your Knowledge)</p> |
| | <p>Correct answer: (d) Controls pertaining to validation of input data in an application Explanation: Controls pertaining to validation of input data in an application is an example of "Application Controls"</p> |
| Q4. | <p>In WH Limited every business activity was being carried out manually. The top management of WH Limited decided to change the business environment of WH Limited by using computer systems and computer systems related technology to carry out all the major business activities of WH Limited. This business environment of WH Limited, where all the major business activities are done using computer systems and computers related technology is an example of:</p> <p>(a) Operational Environment (b) Computational Environment (c) Control Environment. (d) Automated Environment</p> <p>(ICAI MCQs)</p> |
| | <p>Correct answer: (d) Automated Environment Explanation: An automated environment refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems</p> |
| Q5. | <p>IT related risks, if not mitigated, may put an impact on</p> <p>(a) Substantive Audit (b) Controls (c) Reporting (d) All of above</p> <p>(ICAI MCQs)</p> |
| | <p>Correct answer: (d) All of above</p> |
| Q6. | <p>Which of the following is a General IT control?</p> <p>(a) IT Environment (b) Application Control (c) Access Security (d) IT Dependent Control</p> <p>(ICAI MCQs)</p> |
| | <p>Correct answer: (c) Access Security Explanation:</p> <ul style="list-style-type: none"> Types of Controls in an Automated Environment are General IT Control, Application Controls and IT-Dependent |

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| | <p>Controls</p> <ul style="list-style-type: none"> General IT-controls that maintain the integrity of information and security of data commonly include controls over the following: Data center and network operations, Program change, Access security and Application system acquisition, development, and maintenance |
| Q7. | <p>_____are also known as pervasive or indirect controls:-</p> <p>(a) General IT Controls (b) Application Controls (c) IT dependent Controls (d) None of the above</p> <p>(ICAI MCQs)</p> <p>Correct answer: (a) General IT Controls Explanation: General IT Controls are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as “pervasive” controls or “indirect” controls.</p> |
| Q8. | <p>User Training is an activity related to which of the following General IT Controls?</p> <p>(a) Data center and network operations (b) Program change (c) Access security (d) Application system acquisition, development, and maintenance (Business Applications)</p> <p>(ICAI MCQs)</p> <p>Correct answer: (b) Program change</p> |
| Q9. | <p>The Objective of establishing Security Policies and Procedures is to</p> <p>(a) To ensure that production systems are processed to meet financial reporting objectives. (b) To ensure that modified systems continue to meet financial reporting objectives (c) To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives. (d) To ensure that systems are developed, configured and implemented to meet financial reporting objectives.</p> <p>(ICAI MCQs)</p> <p>Correct answer: (c) To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives. Explanation:</p> <ul style="list-style-type: none"> Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives Objective of Program Change to ensure that modified systems continue 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. |
| Q10. | <p>_____ are manual or automated procedures that typically operate at a business process level and apply to the processing of individual applications.</p> <p>(a) Application controls (b) General IT controls (c) Process controls (d) All of these</p> <p>(ICAI MCQs)</p> <p>Correct answer: (a) Application controls Explanation: Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems</p> |

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| Q11. | <p>Which of the following is an automated control?</p> <p>(a) Program change (b) System generated report (c) Application control (d) Configurations</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (c) Application control Explanation: Types of Controls in an Automated Environment are General IT Control, Application Controls and IT-Dependent Controls. Note: Option D is the correct answer as per ICAI MCQs booklet</p> | |
| Q12. | <p>_____ are the manual controls that make use of some form of data or information or report produced from the IT systems and applications.</p> <p>(a) Application (b) IT dependent Controls (c) Automated Controls (d) General IT Controls</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (b) IT dependent Controls Explanation: For a student's understanding, the meaning of different terms are explained below:</p> <ul style="list-style-type: none"> • IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications. In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data. • General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. • Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems. | |
| Q13. | <p>_____ are needed to support the functioning of _____</p> <p>(a) General IT Controls; Application Controls (b) Application Controls; General IT Controls (c) IT Dependent Controls; General IT Controls (d) Application Controls; IT Dependent Controls</p> <p>(ICAI MCQs) (MTP2, May 2023, 1 mark)</p> |
| <p>Correct answer: (a) General IT Controls; Application Controls Explanation: General IT Controls and Application Controls 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.</p> | |
| Q14. | <p>Which of the following Audit testing methods is most effective as an audit test and gives the best audit evidence?</p> <p>(a) Inquiry (b) Observation (c) Inspection (d) Reperformance</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (d) Reperformance Explanation: Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time. Inquiry is the most efficient audit test but it also gives the least audit evidence.</p> | |

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| Q15. | <p>Which of the following Audit Testing methods give the least audit evidence?</p> <p>(a) Inquiry (b) Inspection (c) Observation (d) Reperformance</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (a) Inquiry Explanation: Inquiry is the most efficient audit test but it also gives the least audit evidence</p> | |
| Q16. | <p>Applying _____ gives the most effective and efficient audit evidence while using Audit testing methods.</p> <p>(a) Inquiry in combination with Inspection. (b) Inspection in combination with Observation (c) Observation in combination with reperformance (d) Reperformance in combination with Inquiry</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (a) Inquiry in combination with Inspection Explanation: Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.</p> | |
| Q17. | <p>The standard that requires auditors to analyse journal entries in an audit is?</p> <p>(a) SA 260 (b) SA 230 (c) SA 315 (d) SA 240</p> <p>(ICAI MCQs) (MTP1, May 2019, 1 Mark)</p> |
| <p>Correct answer: (d) SA 240</p> | |
| Q18. | <p>_____ is the combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information:-</p> <p>(a) Computer Assisted Audit Techniques (b) Automated Controls (c) Data Analytics (d) Combination Controls</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (c) Data Analytics</p> | |
| Q19. | <p>The tools and techniques that auditors use in applying the principles of data analytics are known as:</p> <p>(a) Data analytics tools (b) Computer Assisted Auditing Techniques or CAATs in short (c) Analytics tools and techniques (d) System generated tools</p> <p>(ICAI MCQs)</p> |
| <p>Correct answer: (b) Computer Assisted Auditing Techniques or CAATs in short</p> | |
| Q20. | <p>_____ exists when an internal control is either missing or not operating effectively to prevent or detect a misstatement in a timely manner by management</p> <p>(a) Significant Deficiency (b) Operating Deficiency (c) Management Control Deficiency</p> |

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| | (d) Control Deficiency (ICAI MCQs) |
| | Correct answer: (d) Control Deficiency |
| Q21. | _____ is a logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use. (a) Data Mining (b) Data warehouse (c) Database (d) Data Analytics (ICAI MCQs) |
| | Correct answer: (c) Database Explanation: For a student's understanding, meaning of different terms are explained below: <ul style="list-style-type: none"> • Data Mining is the process of analyzing data to find previously unknown trends, patterns, and associations to make decisions. • Data warehouse stores both the historic and transactional data. • Data analytics is the combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information |
| Q22. | _____ is a control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a material misstatement will not be prevented or detected in a timely manner by management. (a) Material Weakness (b) Material deficiency (c) Control Risk (d) Significant Deficiency (ICAI MCQs) |
| | Correct answer: (a) Material Weakness Explanation: <ul style="list-style-type: none"> • Meaning of Significant Deficiency: a control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of TCWG since there is a reasonable possibility that a misstatement will not be prevented or detected in a timely manner by management • Difference b/w Significant Deficiency and material weakness: In significant deficiency, there is a possibility that a misstatement will not be prevented or detected in a timely manner by management and in material weakness, there is a possibility that a material misstatement will not be prevented or detected in a timely manner by management |
| Q23. | A type of super user access to information systems that enforces less or no limits on using that system is known as: (a) Super access. (b) Super user access. (c) Unlimited access. (d) Privileged access (RTP, May 2022, NA) |
| | Correct answer: (d) Privileged access |
| Q24. | Tools and techniques that auditors use in applying the principles of data analytics are known as- (a) Computer Aided Audit Technique (b) Computer Aided Audit Tools (c) Computer Accounting and Auditing Technique (d) Computer Assisted Audit Technique (RTP, May 2023, NA) |

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| | Correct answer: (d) Computer Assisted Audit Technique |
| Q25. | <p>Which of the following is a risk that arises from the use of IT systems?</p> <p>(a) Direct data changes (backend changes). (b) Limited/Monitored access. (c) Adequate segregation of duties. (d) Authorized access to data.</p> <p>(RTP, Nov 2023, NA)</p> |
| | <p>Correct answer: (a) Direct data changes (backend changes). Explanation: Risks arising from use of IT Systems are Inaccurate processing of data, processing inaccurate data, or both, Unauthorized access to data, Direct data changes, Excessive access / Privileged access, Lack of adequate SOD, Unauthorized changes to systems or programs, Failure to make necessary changes to systems or programs, Loss of data</p> |