

# Chapter 1 - Nature, Objective and Scope of Audit - Question Bank

## Part I : Descriptive Questions

### Meaning of Auditing

Q1.	<p>"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon." Explain stating clearly how the person conducting this task should take care to ensure that financial statements would not mislead anybody. (MTP1, Nov 2019, 4 Marks)</p> <p style="text-align: center;"><b>OR</b></p> <p>The person conducting the audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing. (RTP, May 2020, NA) (MTP1, Nov 2021, 4 marks)</p>
	<p>"An audit is <b>independent examination of financial information of any entity</b>, whether <b>profit oriented or not</b>, and irrespective of its <b>size or legal form</b>, when such an examination is conducted with a view to expressing an <b>opinion</b> thereon."</p> <p>Analysis of the definition:</p> <ul style="list-style-type: none"> <li>● Audit is an <b>independent</b> examination of financial information.</li> <li>● Audit applies to various entities, including non-profits (e.g., NGOs, trusts), regardless of size or legal form (e.g., sole proprietorships, partnerships, LLPs, private/public companies, societies, trusts).</li> <li>● The purpose of the audit is to express an <b>opinion</b> on the financial statements.</li> </ul> <p>The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:</p> <ol style="list-style-type: none"> <li>1. the accounts have been drawn up with <b>reference to entries</b> in the books of account;</li> <li>2. the entries in the books of account are adequately supported by <b>sufficient and appropriate evidence</b>;</li> <li>3. none of the entries in the books of account has been <b>omitted</b> in the <b>process of compilation</b> and nothing which is not in the books of account has found place in the statements;</li> <li>4. the information conveyed by the statements is <b>clear and unambiguous</b>;</li> <li>5. the financial statement amounts are <b>properly classified, described and disclosed in conformity with accounting standards</b>; and</li> <li>6. the statement of accounts presents a <b>true and fair picture</b> of the operational results and of the assets and liabilities.</li> </ol>

### Objectives of Audit

Q2.	<p>Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide a picture of healthy financial performance having robust turnover, low debt and good profits. On the above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct? (ICAI Study Material- Test Your Understanding)</p> <ul style="list-style-type: none"> <li>● An audit does not provide assurance to investors in shares regarding safety of his money. Share prices of securities are affected by a range of factors.</li> <li>● An audit only provides <b>reasonable</b> assurance that financial statements are free from material misstatement whether due to fraud or error.</li> </ul> <p><b>Conclusion:</b> Lalji Bhai is <b>not correct</b>.</p>
Q3.	<p>CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA? (SA, May 2022, 3 marks)</p> <p style="text-align: center;"><b>OR</b></p> <p>CA Jatin is the auditor of JP Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements. Explain w.r.t SA 200. (MTP2, May 2023, 3 marks)</p>

	<p style="text-align: center;"><b>OR</b></p> <p>Explain the overall objective of the auditor as contained in SA 200. (RTP, May 2019, NA) (RTP, May 2020, NA)</p> <p style="text-align: center;"><b>OR</b></p> <p>Mr. Z, auditor of the Company, Different and Capable Limited for the financial year 2023-24, explained to audit team members about the objectives of the Independent Auditor in accordance with the relevant Standard on Auditing. Explain those objectives (RTP, Nov 2023, NA)</p>
	<p><b>Overall Objectives of the Independent Auditor:</b></p> <p>As per SA 200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:</p> <ul style="list-style-type: none"> <li>● To obtain <b>reasonable assurance</b> about whether the financial statements as a whole are <b>free from material misstatement</b>, whether due to <b>fraud</b> or <b>error</b>, thereby enabling the auditor to <b>express</b> an <b>opinion</b> on whether the financial statements are <b>prepared, in all material respects</b>, in accordance with an <b>applicable financial reporting framework</b>; and</li> <li>● To <b>report</b> on the financial statements, and <b>communicate</b> as required by the SAs, in accordance with the auditor's findings.</li> </ul> <p>In the given case, the auditor expressed his opinion on the financial statements of the company without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not. Therefore, it can be concluded that the auditor did <b>not comply</b> with the objective of audit as stated in SA 200</p>
Q4.	<p>The auditor of PQR LTD. is unable to obtain sufficient appropriate audit evidence and also the auditor thinks that the possible effects of undetected misstatements on the financial statements would be both material and pervasive. The auditor perceives the situation involving multiple uncertainties there by the auditor concludes that it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements. Advise and explain the type of opinion the auditor would issue in the given circumstances. You are also required to explain the meaning of pervasive in this regard. (MTP2, May 2018, 5 marks)</p>
	<p>The auditor shall <b>disclaim an opinion</b> when the auditor is <b>unable to obtain sufficient appropriate audit evidence</b> on which to base the opinion, and the auditor concludes that the <b>possible effects</b> on the financial statements of <b>undetected misstatements</b>, if any, could be <b>both material and pervasive</b>.</p> <p>The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the <b>potential interaction of the uncertainties and their possible cumulative effect</b> on the financial statements.</p> <p><b>Meaning of Pervasive</b> – A term used, in the context of misstatements, to describe the <b>effects</b> on the financial statements of misstatements <b>or</b> the <b>possible effects</b> on the financial statements of <b>misstatements</b>, if <b>any</b>, that are <b>undetected</b> due to an inability to obtain sufficient appropriate audit evidence.</p> <p><b>Pervasive effects on the financial statements are those that, in the auditor's judgment:</b></p> <ol style="list-style-type: none"> <li>i) Are <b>not confined</b> to specific elements, accounts or items of the financial statements</li> <li>ii) <b>Even</b> if it is <b>confined</b> to a specific element the effect can be considered as pervasive if it represent a <b>substantial proportion</b> of financial statements</li> <li>iii) In relation to <b>disclosures</b>, are <b>fundamental</b> to <b>users' understanding</b> of the financial statements.</li> </ol>

## Test Checking and Judgment

Q5.	<p>"Professional judgment is essential to the proper conduct of an audit." Discuss. (MTP1, Nov 2020, 3 Marks) (SA, Nov 2018, 5 Marks)</p>
	<p><b>Meaning of Professional Judgment:</b> The application of relevant <b>training, knowledge</b> and <b>experience</b>, within the context provided by auditing, accounting and ethical standards, in making <b>informed decisions</b> about the courses of action that are appropriate in the circumstances of the audit engagement.</p> <p><b>Relevant SA:</b> SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with</p>

## Standards on Auditing”

The auditor shall exercise **professional judgment** in planning and performing an audit of financial statements.

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

- **Materiality and audit risk.**
- The **nature, timing, and extent** of audit **procedures** used to meet the requirements of the SAs and gather audit evidence.
- Evaluating whether **sufficient appropriate audit evidence** has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.
- The evaluation of **management's judgments** in applying the entity's applicable financial reporting framework.
- The drawing of **conclusions** based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

## Assertions

Q6. Name the assertions for the following audit procedures:

- i) Year end inventory verification.
- ii) Depreciation has been properly charged on all assets.
- iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.
- iv) All liabilities are properly recorded in the financial statements.
- v) Related party transactions are shown properly.

**(SA, May 2018, 5 Marks) (MTP2, May 2021, 5 Marks) (RTP, Nov 2022, NA)**

**OR**

Name the assertions for the following audit procedures:

- i) Year end inventory verification.
- ii) Depreciation has been properly charged on all assets.
- iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.
- iv) All liabilities are properly recorded in the financial statements

**(MTP2, Nov 2023, 4 marks)**

- i) **Existence** Assertion i.e. Inventory recognized in the balance sheet actually existed as at the period end.
- ii) **Valuation** Assertion i.e. all the assets have been valued appropriately and as per generally accepted accounting policies and practices. This assertion checks whether the depreciation expense has been correctly calculated and allocated among the assets over their useful lives. It ensures that the assets are not over or under-valued in the financial statements as a result of incorrect depreciation charges.
- iii) **Rights & Obligations** Assertion i.e. the entity has valid legal ownership rights over the land claimed to be held by the entity and recorded in the financial statements
- iv) **Completeness** assertion i.e. all the liabilities that were supposed to be recorded have been recognized in the financial statements.
- v) **Presentation & Disclosure** i.e. whether related party transactions have been disclosed appropriately as per the requirements of AS 18 – Related Party Disclosures.

**NOTE:** In ICAI suggested answers, only the assertion name is mentioned. However, the assertion can be explained briefly.

Q7. State assertions that are implied in the extract of financial statement given below:

		₹
Plant & Machinery (at Cost)		4,00,000
Less Depreciation		
Up to Previous year	1,40,000	
For the year	<u>26,000</u>	<u>1,66,000</u>
		2,34,000

- i) Indicate assertions in respect of transactions and events for the period relating to PPE.
- ii) State specific assertions relating to the above extract of financial statements.

(MTP2, May 2019, 6 Marks) (MTP1, May 2021, 6 Marks) (MTP1, Nov 2023, 6 Marks)

- i) **Assertions about transactions and events for the period relating to fixed assets :**
  - **Occurrence**—transactions and events relating to fixed assets have been **recorded**, have occurred and **pertain to the entity**.
  - **Completeness**—all transactions and events relating to fixed assets that **should have been recorded have been recorded**.
  - **Accuracy**—amounts and other data relating to recorded transactions and events have been recorded **appropriately**.
  - **Cut-off**—transactions and events have been recorded in the **correct accounting period**.
  - **Classification**—transactions and events have been recorded in the **proper accounts**.
- ii) **Specific assertions are as follows:**
  - **Rights and Obligation assertion:**
    - the firm **owns** the plant and machinery;
    - the asset is being **utilised** in the **business** of the company productively;
  - **Completeness** : the **historical cost** of plant and machinery is ₹ 4 lacs;
  - **Valuation assertion:**
    - total charge of depreciation on this asset is ₹ 1,66,000 to date on which ₹ 26,000 relates to the year in respect of which the accounts are drawn up; and
    - the **amount** of depreciation has been calculated on recognised basis and the calculation is correct
  - **Existence assertion:** the plant and machinery **physically exists**;

**NOTE: ICAI has not mentioned the assertion names in the suggested answers of (ii) part**

Q8. What are the obvious assertions in the following items appearing in the Financial Statements?

- i) Statement of Profit and Loss  
Travelling Expenditure ₹ 50,000
- ii) Balance Sheet  
Trade receivable ₹ 2,00,000

(MTP1, Nov 2019, 3 Marks)

- i) **Travelling Expenditure ₹ 50,000**
  - **Occurrence:** Expenditure has been **actually incurred** for the purpose of travelling.
  - **Completeness:** Total amount of expenditure incurred is ₹ 50,000 during the year.
  - **Cut-off:** Travelling has been undertaken **during the year** under consideration.
  - **Classification:** It has been treated as **revenue expenditure** and charged to Statement of Profit and Loss.

**NOTE : ICAI has not written anything about Accuracy Assertion**

- ii) **Trade receivable ₹ 2,00,000**
  - **Completeness:**

	<ul style="list-style-type: none"> <li>○ These have been <b>recorded properly</b>, they <b>actually exist</b> and <b>occurred</b> during the year.</li> <li>○ These include <b>all sales transactions</b> that occurred during the year.</li> <li>● <b>Rights and Obligations</b> : These constitute <b>assets</b> of the entity.</li> <li>● <b>Valuation</b>: These have been shown at <b>proper value</b>, i.e. after showing the deduction on account of provision for bad and doubtful debts.</li> </ul>
Q9.	<p>Name the assertion that the auditor will check by performing the following audit procedures.</p> <ol style="list-style-type: none"> <li>a) Employees benefit expense in respect of all personnel have been fully accounted for.</li> <li>b) Discounts on sales has been properly adjusted/ accounted for.</li> <li>c) Employee benefit expense recorded during the period relates to the current accounting period only</li> </ol> <p><b>(MTP1, May 2023, 3 marks)</b></p> <ol style="list-style-type: none"> <li>a) <b>Completeness</b> - all transactions and events that should have been recorded have been recorded)</li> <li>b) <b>Measurement</b> - Transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated</li> <li>c) <b>Cut Off</b> - transactions and events have been recorded in the correct accounting period)</li> </ol> <p><b>NOTE:</b> In ICAI suggested answers, only the assertion name is mentioned. However, the assertion can be explained briefly.</p>

## Scope of Audit

Q10.	<p>Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean. During course of audit by Zoha &amp; Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?</p> <p><b>(ICAI Study Material- Test Your Understanding)</b></p>
	<p><b>Scope of Audit</b></p> <p>The following points are included in scope of audit of financial statements: -</p> <ol style="list-style-type: none"> <li>1. <b>Coverage of all aspects of entity</b> : Audit of FSs should be organized adequately to cover <b>all</b> aspects of the entity relevant to the FSs being audited.</li> <li>2. <b>Reliability and sufficiency of financial information</b> : The auditor should be <b>reasonably</b> satisfied that information contained in underlying <b>accounting records</b> and <b>other</b> source data (like bills, vouchers, documents etc.) is reliable and provide <b>sufficient</b> basis for preparation of financial statements.</li> <li>3. <b>Proper disclosure of financial information</b>: The auditor must ensure FSs adequately <b>disclose relevant</b> information and <b>comply</b> with statutory <b>requirements</b>, verifying that they accurately summarize recorded transactions and considering management's judgments in their preparation.</li> </ol> <p><b>Conclusion:</b> Proper disclosure of financial information is well within scope of audit.</p>
Q11.	<p>A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report? <b>(ICAI Study Material- Test Your Understanding)</b></p>
	<ul style="list-style-type: none"> <li>● An audit is <b>independent examination of financial information of any entity</b>, whether <b>profit oriented or not</b>, and irrespective of its <b>size or legal form</b>, when such an examination is conducted with a view to expressing an <b>opinion</b> thereon</li> <li>● An audit is <b>not an official investigation</b> into alleged <b>wrongdoing</b>.</li> <li>● In the given case, appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company.</li> </ul> <p><b>Conclusion:</b> Services rendered by CA are in the <b>nature of investigation</b> and therefore his report will not be in the nature of</p>

	audit report.
Q12.	<p>“Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management”. Do you agree? Discuss duty of auditor, if any, in relation to accounting policies. <b>(ICAI Study Material - Test Your Knowledge)</b></p> <ul style="list-style-type: none"> <li>• Choosing appropriate accounting policies is the <b>responsibility of management</b>. The role of auditor lies in evaluating selection and consistent application of accounting policies by management</li> <li>• The auditor <b>evaluates management's judgments</b> in FS preparation, including the selection and consistent application of accounting policies, such as depreciation methods for fixed assets and inventory valuation, ensuring proper choice and period-to-period consistency.</li> </ul>
Q13.	<p>An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. Discuss. <b>(RTP, May 2023, NA)</b></p> <ul style="list-style-type: none"> <li>• Audit is distinct from investigation. <b>Investigation</b> is a <b>critical examination</b> of the accounts with a <b>special purpose</b>. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.</li> <li>• The objective of audit is to obtain <b>reasonable</b> assurance about whether the financial statements as a whole are <b>free</b> from <b>material misstatement</b>, whether due to <b>fraud</b> or <b>error</b>, thereby enabling the auditor to express an <b>opinion</b>.</li> <li>• Therefore, <b>audit</b> is <b>never</b> started with a <b>preconceived notion</b> about state of affairs; about <b>wrong-doing</b>; about some wrong having been committed. The auditor seeks to report what he finds in the normal course of examination of accounts.</li> <li>• However, it is quite possible that sometimes investigation results from the <b>prima facie findings</b> of the auditor. It may happen that the auditor has given some findings of serious concern. Such findings may prompt for calling an investigation</li> </ul>

## Benefits of Audit

Q14.	<p>RAG is proprietorship firm engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs. 5 crores from Canara Bank. In the year 2023-24, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches a CA about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited. <b>(MTP1, May 2018, 5 Marks) (MTP2, Nov 2018, 5 Marks)</b></p> <p style="text-align: center;"><b>OR</b></p> <p>The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory. Explain. <b>(RTP, Nov 2018, NA)</b></p> <p><b>Advantages of audit of Financial statements:</b></p> <ul style="list-style-type: none"> <li>• Audited accounts provide <b>high quality information</b>. It gives <b>confidence</b> to <b>users</b> that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.</li> <li>• In case of companies, shareholders may or may not be involved in daily affairs of the company. The FSs are prepared by management consisting of directors. As shareholders are owners of the company, they need an <b>independent mechanism</b> so that financial information is <b>qualitative</b> and <b>reliable</b>. Hence, their interest is <b>safeguarded</b> by an audit.</li> <li>• An audit acts as a <b>moral check</b> on <b>employees</b> from committing frauds for the fear of being discovered by audit.</li> <li>• Audited FSs are helpful to <b>government</b> authorities for determining tax liabilities.</li> <li>• Audited FSs can be relied upon by <b>lenders</b>, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.</li> <li>• An audit may also <b>detect fraud</b> or <b>error</b> or both.</li> <li>• An audit <b>reviews</b> the <b>existence</b> and <b>operations</b> of various <b>controls</b> operating in any entity. Hence, it is useful at pointing out deficiencies.</li> </ul>
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## Inherent Limitations of Audit

Q15.	<p>Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ &amp; Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm. However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel.</p> <p>The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation. <b>(ICAI Study Material- Test Your Understanding)</b></p>
	<ul style="list-style-type: none"> <li>● The auditor is <b>not expected</b> to, and <b>cannot, reduce</b> audit risk to <b>zero</b> and <b>cannot</b> therefore <b>obtain absolute assurance</b> that the financial statements are free from material misstatement due to fraud or error. This is because there are <b>inherent limitations</b> of an audit.</li> <li>● Circumstances given in the question is an example of <b>failure of internal controls</b> of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls.</li> </ul> <p><b>Conclusion:</b> The view of the partners is <b>not correct</b>. This is an inherent limitation of audit.</p>
Q16.	<p>An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance. <b>(ICAI Study Material - Test Your Knowledge) (MTP2, Nov 2023, 3 marks)</b></p> <p style="text-align: center;"><b>OR</b></p> <p>There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with examples. <b>(RTP, May 2020, NA) (MTP1, Nov 2020, 3 Marks) (RTP, Nov 2021, NA) (RTP, Nov 2023, NA)</b></p>
	<p><b>The Nature of Audit Procedures</b></p> <ul style="list-style-type: none"> <li>● An auditor does <b>not test all transactions</b> and <b>balances</b>. He forms his opinion only by testing <b>samples</b>. It is an example of practical limitation on auditor's ability to obtain audit evidence.</li> <li>● Management may <b>not provide complete information</b> as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.</li> <li>● The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing <b>fraud</b> by designing <b>sophisticated</b> and carefully <b>organized schemes</b> which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.</li> <li>● It is quite possible that the entity may have entered into some transactions with <b>related parties</b>. Such transactions may be only paper transactions and may not have actually occurred. The auditor may <b>not be aware</b> of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.</li> </ul>
Q17.	<p>The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. Explain. <b>(RTP, Nov 2018, NA)</b></p>
	<p>The auditor is <b>not expected</b> to, and <b>cannot, reduce</b> audit risk to <b>zero</b> and <b>cannot</b> therefore <b>obtain absolute</b> assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. The inherent limitations of an audit arise from:</p> <ol style="list-style-type: none"> <li>1. <b>The Nature of Financial Reporting:</b> Preparation of financial statements involves making many <b>judgments</b> by management. These judgments may involve <b>subjective</b> decisions or a degree of <b>uncertainty</b>. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors</li> <li>2. <b>The Nature of Audit Procedures:</b> There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example,       <ul style="list-style-type: none"> <li>● an auditor does <b>not test all transactions</b> and <b>balances</b>. He forms his opinion only by testing <b>samples</b>. It is an example of a practical limitation on an auditor's ability to obtain audit evidence.</li> </ul> </li> </ol>

	<ul style="list-style-type: none"> <li>Management may <b>not provide complete information</b> as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.</li> </ul> <p>3. <b>Not in nature of investigation:</b> An audit is <b>not</b> an <b>official investigation</b>. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors</p> <p>4. <b>Timeliness of Financial Reporting and the Balance between Benefit and Cost:</b> The relevance of information decreases over time and auditor <b>cannot</b> verify each and every matter. Therefore, a <b>balance</b> has to be struck between <b>reliability</b> of information and <b>cost</b> of obtaining it.</p> <p>5. <b>Future events:</b> Future events or conditions may affect an entity adversely. <b>Adverse events</b> may seriously affect an entity's ability to continue its business. The business may <b>cease to exist</b> in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.</p>
Q18.	<p>There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain giving examples. Also explain the difference between audit and investigation. (RTP, Nov 2022, NA)</p> <p><b>The Nature of Audit Procedures:</b> There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example,</p> <ul style="list-style-type: none"> <li>An auditor does <b>not test all transactions and balances</b>. He forms his opinion only by testing <b>samples</b>. It is an example of practical limitation on auditor's ability to obtain audit evidence.</li> <li>Management may <b>not provide complete information</b> as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.</li> <li>The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing <b>fraud</b> by designing <b>sophisticated</b> and carefully <b>organized schemes</b> which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.</li> <li>It is quite possible that the entity may have entered into some transactions with <b>related parties</b>. Such transactions may be only paper transactions and may not have actually occurred. The auditor may <b>not be aware</b> of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.</li> </ul> <p><b>Difference between audit and investigation</b></p> <ul style="list-style-type: none"> <li>An audit is <b>not</b> an <b>official investigation</b> into alleged <b>wrongdoing</b>. He does <b>not</b> have any specific <b>legal powers</b> of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.</li> <li><b>Investigation</b> is a <b>critical examination</b> of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.</li> <li>The objective of audit is to obtain <b>reasonable</b> assurance about whether the financial statements as a whole are free from <b>material misstatement</b>, whether due to <b>fraud</b> or <b>error</b>, thereby enabling the auditor to express an opinion.</li> <li>The scope of audit is general and <b>broad</b> whereas scope of investigation is specific and <b>narrow</b></li> </ul>

### Interdisciplinary Nature of Auditing relationship with Diverse Subjects

Q19.	<p>Both accounting and auditing are closely related with each other. Explain (RTP, Nov 2020, NA)</p> <ul style="list-style-type: none"> <li>Both accounting and auditing are <b>closely related</b> with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process.</li> <li>Auditing <b>begins when accounting ends</b>.</li> <li>It requires that the auditor must have a <b>thorough</b> and sound <b>knowledge</b> of <b>generally accepted principles</b> of accounting before he can review the financial statements.</li> </ul>
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## Assurance Engagement

Q20.	<p>The management of Exotic Tours and Travels Limited requests its auditor Raja &amp; Co. to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures. Can Raja &amp; Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case? <b>(ICAI Study Material- Test Your Understanding)</b></p>
	<p>In the given case, Raja &amp; Co. can provide a <b>review report</b>. Review is a <b>limited</b> assurance engagement and it provides assurance which is lower than that provided by audit. It is due to the fact that review involves fewer procedures as compared to audit.</p> <p>Therefore, Raja &amp; Co can provide a report as requested by the management of the company. Such a report would be in the nature of <b>“review”</b>.</p> <p>Raja &amp; Co is required to obtain sufficient appropriate evidence based on limited procedures performed.</p>
Q21.	<p>Assurance engagements are not restricted to audit of financial statements alone. Discuss. <b>(ICAI Study Material - Test Your Knowledge)</b></p>
	<ul style="list-style-type: none"> <li>● “Assurance engagement” means an engagement in which a practitioner expresses a <b>conclusion</b> designed to enhance the <b>degree of confidence</b> of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.</li> <li>● Scope of Assurance engagements is <b>not restricted</b> to <b>audit</b> of financial statements only, it also extends to examination of prospective financial information and examination of internal controls.</li> <li>● Example of assurance engagement             <ul style="list-style-type: none"> <li>○ <b>Audit</b> of financial statements - <b>Reasonable</b> assurance engagement</li> <li>○ <b>Review</b> of financial statements - <b>Limited</b> assurance engagement</li> <li>○ <b>Examination of Prospective financial information</b> - Provides <b>assurance</b> regarding <b>reasonability</b> of assumptions forming basis of projections and related matters</li> <li>○ <b>Report</b> on controls operating at an organization - Provides <b>assurance</b> regarding <b>design</b> and <b>operation</b> of <b>controls</b></li> </ul> </li> </ul>
Q22.	<p>An assurance engagement involves a three party relationship. Discuss meaning of three parties in such an engagement <b>(ICAI Study Material - Test Your Knowledge)</b></p>
	<p>A three party relationship involving a practitioner, a responsible party, and intended users</p> <ul style="list-style-type: none"> <li>● <b>Practitioner:</b> A practitioner is a person who <b>provides assurance</b>. The term practitioner is broader than auditor. <b>Audit</b> is related to <b>historical</b> information whereas <b>practitioner</b> may provide assurance <b>not necessarily</b> related to <b>historical</b> financial information.</li> <li>● <b>Responsible party:</b> A responsible party is the party <b>responsible</b> for <b>preparation</b> of <b>subject matter</b>.</li> <li>● <b>Intended users:</b> Intended users are the persons for <b>whom</b> an assurance <b>report</b> is <b>prepared</b>. These persons may use the report in making <b>decisions</b>.</li> </ul>
Q23.	<p>A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement. <b>(ICAI Study Material - Test Your Knowledge)</b></p>
	<ul style="list-style-type: none"> <li>● “Assurance engagement” means an engagement in which a practitioner expresses a <b>conclusion</b> designed to <b>enhance</b> the <b>degree of confidence</b> of the intended <b>users</b> other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.</li> <li>● Reasonable assurance is a <b>high level</b> of assurance but it is <b>not absolute</b> assurance</li> <li>● In the given case, a Chartered Accountant is specifically asked to check accounts whether fraud exists.</li> <li>● It is not a reasonable assurance engagement. It is in the <b>nature of investigation</b>.</li> </ul>

## Qualities of Auditor

Q24.	<p>Explain qualities of an Auditor. <b>(RTP, May 2019, NA) (MTP1, May 2021, 4 Marks) (MTP1, Nov 2021, 4 Marks)</b></p>
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**Qualities of an Auditor:**

- **Tact, caution**, firmness, good temper, integrity, discretion, industry, judgment, patience, clear headedness and reliability are some of qualities which an auditor should have. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor.
- He must have the highest degree of **integrity** backed by adequate independence.
- The auditor, who holds a position of **trust**, must have the basic human qualities apart from the technical requirement of professional training and education.
- **Knowledge of an expert**. He is called upon constantly to critically review FSs and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert.
- An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know **thoroughly all accounting principles and techniques**.

**Quality Control and Engagement Standards**

Q25.	<p>CA. P Babu is conducting an audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing. Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing? <b>(ICAI Study Material- Test Your Understanding)</b></p> <ul style="list-style-type: none"> <li>● It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them. Ordinarily, these are to be followed by professional accountants.</li> <li>● However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, professional accountant is required to             <ul style="list-style-type: none"> <li>○ <b>Document</b> how alternative procedures performed achieve the purpose of the required procedure.</li> <li>○ <b>Reason for departure</b> has to be documented</li> <li>○ <b>Report</b> should draw attention to such departures</li> </ul> </li> </ul> <p><b>Conclusion:</b> Hence, CA. P Babu is required to follow the above procedure.</p>
Q26.	<p>Standards on Auditing (SAs) apply in “audit of historical financial information” whereas Standards on Review Engagements (SREs) apply in “review of historical financial information.” Explain in detail giving examples. <b>(RTP, May 2022, NA)</b></p> <p>Standards on auditing apply in “<b>audit</b>” of historical financial information which is a <b>reasonable</b> assurance engagement whereas Standards on Review Engagements apply in “<b>review</b>” of historical financial information which is a <b>limited</b> assurance engagement only.</p> <p>“<b>Historical financial information</b>” means information expressed in <b>financial</b> terms in relation to a particular entity, derived primarily from that entity’s accounting system, about economic <b>events</b> occurring in <b>past</b> time periods or about economic conditions or circumstances at points in time in the past.</p> <p>“Audit” and “Review” are two different terms. <b>Audit</b> is a <b>reasonable</b> assurance engagement, and its <b>objective</b> is <b>reduction</b> in assurance engagement <b>risk</b> to an <b>acceptably low level</b> in the circumstances of the engagement. However, “<b>review</b>” is a <b>limited</b> assurance engagement, and its <b>objective</b> is a <b>reduction</b> in assurance engagement <b>risk</b> to a <b>level</b> that is <b>acceptable</b> in the <b>circumstances</b> of the engagement,</p> <p>Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements. Some examples of Standards on Auditing are :</p> <ul style="list-style-type: none"> <li>● <b>SA 200</b> Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing</li> <li>● <b>SA 230</b> Audit Documentation</li> <li>● <b>SA 315</b> Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment</li> <li>● <b>SA 500</b> Audit Evidence</li> </ul>

- **SA 700** Forming an Opinion and Reporting on Financial Statements

Examples of Standards on Review engagements are

- **SRE 2400** (Revised) Engagements to Review Historical Financial Statements
- **SRE 2410** Review of Interim Financial Information Performed by the Independent Auditor of the Entity

## Part II: Correct/Incorrect Questions

Q1.	The basic objective of audit does not change with reference to nature, size or form of an entity. <b>(ICAI Study Material- Test Your Knowledge)</b>
	<b>Correct.</b> An audit is <b>independent examination</b> of <b>financial information</b> of <b>any entity</b> , whether <b>profit oriented or not</b> , and irrespective of its <b>size or legal form</b> , when such an examination is conducted with a view to expressing an <b>opinion</b> thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does <b>not change</b> with reference to nature, size or form of an entity.
Q2.	The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. <b>(ICAI Study Material- Test Your Knowledge) (MTP1, May 2023, 2 marks)</b>
	<b>Correct.</b> As per <b>SA 200</b> "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to <b>enhance the degree of confidence</b> of intended <b>users</b> in the financial statements. This is achieved by the expression of an <b>opinion</b> by the auditor on whether the <b>financial statements</b> are prepared, in <b>all material</b> respects, in accordance with an <b>applicable financial reporting framework</b> .
Q3.	The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. <b>(ICAI Study Material- Test Your Knowledge)</b>
	<b>Correct.</b> As per <b>SA 200</b> "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is <b>not expected</b> to, and <b>cannot, reduce audit risk to zero</b> and <b>cannot</b> therefore obtain <b>absolute</b> assurance that the <b>financial statements</b> are <b>free</b> from <b>material misstatement</b> due to fraud or error. This is because there are <b>inherent limitations</b> of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being <b>persuasive</b> rather than conclusive.
Q4.	Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. <b>(ICAI Study Material- Test Your Knowledge) (MTP1, Nov 2020, 2 Marks) (SA, July 2021, 2 Marks) (RTP, May 2023, NA) (MTP1, May 2023, 2 marks)</b>
	<b>Incorrect.</b> Assertions refer to <b>representations</b> by <b>management</b> that are embodied in the financial statements as <b>used</b> by the <b>auditor</b> to consider the different types of the potential misstatements that may occur.
Q5.	Mr. S, one of the new team members of the auditor of Extremely Effective Limited was of the view that for the purpose of conducting an audit, only knowledge of direct tax is required whereas no knowledge of indirect tax is required. <b>(Old ICAI Study Material)</b>
	<b>Incorrect.</b> The viewpoint of Mr. S is incorrect because for the purpose of conducting an audit, proper knowledge of <b>both</b> direct tax as well as indirect tax is required.
Q6.	According to Mr. H, one of the team members of the auditor of Very Essential Limited was of the view that no relation exists between accounting and auditing from the point of view of a company. <b>(Old ICAI Study Material)</b>
	<b>Incorrect.</b> The viewpoint of Mr. H is incorrect because there exists a <b>proper relation</b> between accounting and auditing from the point of view of a company. Audit is conducted for financial statements of a company and those financial statements are prepared with the help of books of accounts of that company. In order to properly conduct an audit of a company, an auditor is required to be aware of accounting <b>principles</b> and accounting <b>policies</b> of that company.
Q7.	The term "Engagement Standards" refer to Standards on Auditing only. <b>(Old ICAI Study Material)</b>

	<b>Incorrect.</b> Engagement Standards refer not only to Standards on auditing but also to <b>Standards on review engagements, Standards on assurance engagements</b> and <b>Standards on related services</b> .
Q8.	The objective of audit is to obtain absolute assurance and to report on the financial statements. <b>(RTP, May 2018, NA)</b> <b>OR</b> As per SA 200 "Overall Objectives of the Auditor", in conducting an audit of financial statements, the overall objectives of the auditor is to obtain absolute assurance about whether the financial statements as a whole are free from material misstatement due to fraud. <b>(RTP, May 2023, NA)</b>
	<b>Incorrect.</b> As per <b>SA 200</b> "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", in conducting an audit of financial statements, the overall objectives of the auditor are: <ul style="list-style-type: none"> <li>• To obtain <b>reasonable assurance</b> about whether the <b>financial statements</b> as a whole are <b>free</b> from <b>material misstatement</b>; whether due to fraud or error, thereby enabling the auditor to express an <b>opinion</b> on whether the financial statements are prepared, in all material respects, in accordance with an <b>applicable financial reporting framework</b>; and</li> <li>• To <b>report</b> on the financial statements, and <b>communicate</b> as required by the SAs, in accordance with the auditor's findings</li> </ul>
Q9.	As explained in SA 200, absolute assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk. <b>(MTP2, May 2018, 2 Marks)</b>
	<b>Incorrect.</b> As explained in <b>SA 200</b> , "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", <b>reasonable assurance</b> is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.
Q10.	Misstatements in the financial statements can arise from fraud only. <b>(MTP1, May 2018, 2 Marks) (MTP1, Nov 2018, 2 Marks) (MTP2, Nov 2018, 2 Marks)</b> <b>OR</b> Misstatement in the financial statement is always because of fraud <b>(SA, July 2021, 2 Marks)</b>
	<b>Incorrect.</b> Misstatements in the financial statements can arise from <b>either fraud or error</b> . The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is <b>intentional or unintentional</b> . The ' <b>fraud</b> ' deals with <b>intentional</b> misrepresentation but, ' <b>error</b> ', on the other hand, refers to <b>unintentional</b> mistakes in financial information.
Q11.	The preparation of financial statements does not involve judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. <b>(RTP, Nov 2018, NA) (RTP, May 2019, NA)</b>
	<b>Incorrect.</b> The preparation of financial statements involves <b>judgment by management</b> in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve <b>subjective</b> decisions or assessments or a degree of <b>uncertainty</b> , and there may be a range of acceptable interpretations or judgments that may be made.
Q12.	An audit is an official investigation into alleged wrongdoing. <b>(RTP, Nov 2018, NA) (RTP, May 2019, NA)</b>
	<b>Incorrect.</b> An audit is <b>not an official investigation</b> into alleged <b>wrongdoing</b> . Accordingly, the auditor is <b>not</b> given specific <b>legal powers</b> , such as the power of search, which may be necessary for such an investigation.
Q13.	Management of the organization is solely responsible for the compliance of auditing standards while preparing financial statements. <b>(SA, Nov 2018, 2 Marks)</b>
	<b>Incorrect.</b> The management is responsible for the <b>preparation</b> of the <b>financial statements</b> in accordance with the applicable financial reporting framework. Management is responsible for the compliance of <b>accounting standards</b> . The <b>auditor</b> is responsible for the compliance of <b>standards on auditing</b> while auditing the financial statements of the entity.

Q14.	<p>The objective of audit is to obtain absolute assurance about whether the financial statements as a whole are free from material misstatement. <b>(MTP2, May 2019, 2 Marks)</b></p> <p style="text-align: center;"><b>OR</b></p> <p>The auditor is expected to and can reduce audit risk to zero. <b>(MTP1, May 2020, 2 Marks)</b></p>
	<p><b>Incorrect.</b> As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the objective of audit is to obtain <b>reasonable</b> assurance about whether the financial statements as a whole are free from material misstatement. In auditing, reasonable assurance can be given which is <b>high level</b> assurance but not absolute assurance. The auditor is <b>not expected</b> to, and <b>cannot, reduce</b> audit risk to <b>zero</b> and <b>cannot</b> therefore <b>obtain absolute</b> assurance that the <b>financial statements</b> are <b>free</b> from <b>material misstatement</b> due to fraud or error. This is because there are <b>inherent limitations</b> of an audit.</p>
Q15.	<p>The Auditor is expected to reduce audit risk to zero and can therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. <b>(SA, Jan 2021, 2 Marks) (MTP2, Nov 2022, 2 Marks)</b></p> <p style="text-align: center;"><b>OR</b></p> <p>The auditor is expected to, and can, reduce audit risk to zero and can therefore obtain absolute assurance. <b>(MTP1, Nov 2021, 2 Marks)</b></p>
	<p><b>Incorrect.</b> As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", The auditor is <b>not expected</b> to, and <b>cannot, reduce</b> audit risk to <b>zero</b> and <b>cannot</b> therefore <b>obtain absolute</b> assurance that the <b>financial statements</b> are <b>free</b> from <b>material misstatement</b> due to fraud or error. This is because there are <b>inherent limitations</b> of an audit.</p>
Q16.	<p>There are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being conclusive rather than persuasive. <b>(MTP2, May 2021, 2 Marks)</b></p>
	<p><b>Incorrect.</b> As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is <b>not expected</b> to, and <b>cannot, reduce</b> audit risk to <b>zero</b> and <b>cannot</b> therefore obtain <b>absolute</b> assurance that the <b>financial statements</b> are <b>free</b> from <b>material misstatement</b> due to fraud or error. This is because there are <b>inherent limitations</b> of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being <b>persuasive</b> rather than conclusive.</p>
Q17.	<p>Audit procedures used to gather audit evidence may be effective for detecting an intentional misstatement. <b>(RTP, Nov 2018, NA) (RTP, May 2019, NA)</b></p>
	<p><b>Incorrect.</b> Fraud may involve <b>sophisticated</b> and carefully <b>organized</b> schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be <b>ineffective</b> for detecting an intentional misstatement. The auditor is <b>neither trained</b> as <b>nor</b> expected to be an <b>expert</b> in the <b>authentication</b> of documents.</p>
Q18.	<p>The preparation of financial statements involves judgment by management. <b>(MTP2, Nov 2021, 2 Marks) (MTP1, May 2022, 2 marks)</b></p>
	<p><b>Correct.</b> The preparation of financial statements involves <b>judgment</b> by <b>management</b> in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve <b>subjective</b> decisions or assessments or a degree of <b>uncertainty</b>, and there may be a range of acceptable interpretations or judgments that may be made.</p>
Q19.	<p>Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence. <b>(SA, May 2022, 2 Marks)</b></p>
	<p><b>Incorrect.</b> Pervasive is a term used, in the context of <b>misstatements</b>, to describe the effects on the financial statements of misstatements or the <b>possible effects</b> on the financial statements of misstatements, if any, that are <b>undetected</b> due to an inability to obtain sufficient appropriate audit evidence.</p>
Q20.	<p>There is no difference between "audit" and "review." <b>(RTP, Nov 2022, NA)</b></p>
	<p><b>Incorrect.</b> "Audit" and "Review" are two different terms. <b>Audit</b> is a <b>reasonable</b> assurance engagement, and its <b>objective</b> is</p>

	<b>reduction</b> in assurance engagement <b>risk</b> to an <b>acceptably low</b> level in the circumstances of the engagement. However, “ <b>review</b> ” is a <b>limited</b> assurance engagement, and its <b>objective</b> is a <b>reduction</b> in assurance engagement <b>risk</b> to a <b>level</b> that is <b>acceptable</b> in the <b>circumstances</b> of the engagement
Q21.	For auditor’s opinion, reasonable assurance is an absolute level of assurance. <b>(RTP, Nov 2022, NA) (RTP, Nov 2023, NA)</b>  <b>Incorrect.</b> Reasonable assurance is a <b>high</b> level but <b>not</b> an <b>absolute</b> level of assurance, because there are <b>inherent limitations</b> of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being <b>persuasive</b> rather than conclusive.
Q22.	Negative assertions, encountered in the financial statements, may be expressed or implied. <b>(RTP, Nov 2022, NA) (MTP2, Nov 2023, 2 marks)</b>  <b>Correct.</b> Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is <b>no contingent liability</b> it would be an expressed <b>negative assertion</b> ; on the other hand, if in the balance sheet there is no item as “building”, it would be an <b>implied negative assertion</b> that the entity did not own any building on the balance sheet date.
Q23.	Misstatements in the financial statements can arise from either fraud or error. <b>(MTP1, Nov 2022, 2 Marks)</b>  <b>Correct.</b> Misstatements in the financial statements can arise from <b>either fraud or error</b> . The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is <b>intentional</b> or <b>unintentional</b> . Hence misstatement can arise from error or fraud.
Q24.	Historical financial information relates to financial information based on assumptions about occurrence of future events and possible actions by an entity. <b>(SA, Nov 2022, 2 marks) (MTP2, Nov 2023, 2 marks)</b>  <b>Incorrect.</b> <b>Historical</b> financial information relates to information expressed in <b>financial</b> terms of an entity about <b>economic events</b> , conditions or circumstances occurring in <b>past</b> periods. Whereas <b>financial information</b> based on assumptions about occurrence of <b>future</b> events and possible actions by an entity relates to prospective financial information.

### Part III: Multiple Choice Questions

Q1.	Which of the following is not an advantage of audit? (a) It provides high quality financial information. (b) It acts as a moral check on employees. (c) It enhances risk of management bias. (d) It helps in safeguarding interests of shareholders. <b>(ICAI Study Material - Test Your Knowledge)</b>  <b>Correct answer:</b> (c) It enhances risk of management bias <b>Explanation:</b> Advantages of Audit are- provides high quality financial information, acts as a moral check on employees, helps in safeguarding interests of shareholders, helpful to government authorities, relied upon by lenders, detect fraud or error, and reviews existence and operations of various controls. “It enhances risk of management bias” is not an advantage of audit.
Q2.	Which of the following is NOT TRUE about an assurance engagement? (a) It relates to providing assurance about historical financial information only. (b) The practitioner obtains sufficient appropriate evidence. (c) There is some information to be examined by practitioner. (d) A written assurance report in appropriate form is issued by practitioner. <b>(ICAI Study Material - Test Your Knowledge)</b>  <b>Correct answer:</b> (a) It relates to providing assurance about historical financial information only. <b>Explanation:</b> Assurance can also be related to matters other than historical financial information. Such an assurance may relate to prospective financial information. It may relate to providing assurance on internal controls in an entity. Hence, statement 1 is incorrect.

Q3.	<p>Which of the following is TRUE about Engagement Standards?</p> <p>(a) Engagement standards ensure proper rights to practitioners in course of performance of their duties.  (b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner.  (c) Engagement standards ensure uniformity by practitioners in course of performance of their duties.  (d) Engagement standards ensure savings in resources of clients</p> <p><b>(ICAI Study Material - Test Your Knowledge)</b></p>
	<p><b>Correct answer:</b> (c) Engagement standards ensure uniformity by practitioners in course of performance of their duties  <b>Explanation:</b> Standards are needed for carrying out audits against established benchmarks, for improving quality of financial reporting, for promoting uniformity, for equipping professional accountants with professional knowledge &amp; skill and for ensuring audit quality.</p>
Q4.	<p>Consider following statements in relation to "Limited assurance engagement":-  Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.  Statement II - Review of interim financial information of a company is an example of limited assurance engagement.</p> <p>(a) Statement I is correct. Statement II is incorrect.  (b) Both Statements I and II are correct.  (c) Both Statements I and II are incorrect.  (d) Statement I is incorrect. Statement II is correct.</p> <p><b>(ICAI Study Material - Test Your Knowledge)</b></p>
	<p><b>Correct answer:</b> (d) Statement I is incorrect. Statement II is correct  <b>Explanation:</b> In reasonable assurance engagements, the practitioner obtains sufficient appropriate evidence to be able to draw reasonable conclusions. Whereas, in Limited assurance engagements, the practitioner obtains sufficient appropriate evidence to be able to draw limited conclusions. Therefore, statement 1 is incorrect. Example of SRE is SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity</p>
Q5.	<p>Which of the following is TRUE about Standards on auditing?</p> <p>(a) These deal mainly with voluntary responsibilities of auditors.  (b) These deal mainly with mandatory responsibilities of auditors.  (c) Their sole purpose is to help government authorities in augmenting revenues.  (d) These deal mainly in carrying out audit according to legal provisions</p> <p><b>(ICAI Study Material - Test Your Knowledge)</b></p>
	<p><b>Correct answer:</b> (b) These deal mainly with mandatory responsibilities of auditors.  <b>Explanation:</b> Engagement Standards issued under the authority of Council of ICAI deal with responsibilities of auditor/practitioner.</p>
Q6.	<p>As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", _____ is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.</p> <p>(a) absolute assurance  (b) limited assurance  (c) reasonable assurance  (d) reasonable or absolute assurance</p> <p><b>(Sample MCQs) (ICAI MCQs)</b></p>
	<p><b>Correct answer:</b> (c) reasonable assurance  <b>Explanation:</b></p> <ul style="list-style-type: none"> <li>• <b>Absolute assurance</b> means that there is absolutely no misstatement in the financial statement and thus financial statements are absolutely reliable and relevant for the user of financial statements.</li> <li>• On the other hand, <b>reasonable assurance</b> is also a high level of assurance but it means that auditor has conducted the audit in a way that he is reasonably sure (to the best possible extent) that financial statements are free from material misstatement but there might be some misstatements that go undetected due to inherent limitations of an audit.</li> </ul>

Q7.	<p>Which of the following is not an assertion about presentation and disclosure?</p> <p>(a) Occurrence and rights and obligations  (b) Completeness  (c) Classification and understandability  (d) Existence</p> <p><b>(Sample MCQs)</b></p>
	<p><b>Correct answer:</b> (d) Existence</p> <p><b>Explanation:</b></p> <ul style="list-style-type: none"> <li>Existence is not an assertion about presentation and disclosure. It is an assertion for account balance.</li> <li>Assertions about presentation and disclosure: Occurrence and rights and obligations, Completeness, Classification and understandability, Accuracy and valuation</li> </ul>
Q8.	<p>Which of the following Assertion is not related to assertion about presentation and disclosure:</p> <p>(a) Occurrence and rights and obligations  (b) Completeness  (c) Classification and understandability  (d) Valuation and allocation</p> <p><b>(Sample MCQs)</b></p>
	<p><b>Correct answer:</b> (d) Valuation and allocation</p> <p><b>Explanation:</b></p> <ul style="list-style-type: none"> <li>Valuation and allocation is not related to assertion about presentation and disclosure. It is an assertion for account balance.</li> <li>Assertions about presentation and disclosure: Occurrence and rights and obligations, Completeness, Classification and understandability, Accuracy and valuation</li> </ul>
Q9.	<p>As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:</p> <p>(a) To obtain reasonable assurance  (b) To report on the financial statements  (c) Both (a) and (b) above  (d) to obtain absolute assurance.</p> <p><b>(ICAI MCQs)</b></p>
	<p><b>Correct answer:</b> (c) Both (a) and (b) above</p> <p><b>Explanation:</b> The objective of the auditor as per SA 200 is to obtain reasonable assurance about whether FS as a whole are free from material misstatement, whether due to fraud or error and to report on FS and communicate as required by SAs.</p>
Q10.	<p>An employee of Fruits and Vegetables Limited was of the opinion that auditor of a company is required to express an opinion. On which one of the following the auditor of a company is required to express an opinion:</p> <p>(a) Only Balance Sheet of the Company.  (b) Financial Statements of the Company.  (c) Only Profit and Loss Account of the Company.  (d) Only Cash Flow Statement of the Company.</p> <p><b>(ICAI MCQs)</b></p>
	<p><b>Correct answer:</b> (b) Financial Statements of the Company.</p> <p><b>Explanation:</b> The auditor is required to express an opinion on the Financial Statements. Financial statements include Balance Sheet, Profit and Loss Account and Cash Flow Statement.</p>
Q11.	<p>The auditor of Delicious Sweets Limited was of the opinion that the objective of audit of financial statements of a company is to provide reasonable assurance that financial statements of that company are free from misstatements. Which type of misstatements are mentioned by auditor of Delicious Sweets Limited:</p> <p>(a) Simple</p>



	<p>(b) Material (c) Easy (d) Competent <b>(ICAI MCQs)</b></p>
	<p><b>Correct answer:</b> (b) Material <b>Explanation:</b> The objective of audit is to obtain reasonable assurance about whether the financial statements as a whole are free from <b>material</b> misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.</p>
Q12.	<p>_____ along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. (a) Auditing (b) Taxation (c) Finance (d) Law <b>(ICAI MCQs)</b></p>
	<p><b>Correct answer:</b> (a) Auditing</p>
Q13.	<p>No business or institution can effectively carry on its activities without the help of proper _____: (a) Audit (b) Record and accounts (c) neither (a) nor (b) (d) both (a) and (b) <b>(ICAI MCQs)</b></p>
	<p><b>Correct answer:</b> (b) Record and accounts</p>
Q14.	<p>Which of the following is the responsibility of the auditor: (a) Preparation and presentation of the financial statements in accordance with applicable financial reporting (b) Design, implementation and maintenance of internal controls (c) Express an opinion on the Financial Statements (d) To obtain limited assurance <b>(ICAI MCQs) (MTP2, May 2022, 1 mark)</b></p>
	<p><b>Correct answer:</b> (c) Express an opinion on the Financial Statements <b>Explanation:</b></p> <ul style="list-style-type: none"> <li>• The responsibility of the auditor is to obtain reasonable assurance about whether the FSs as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the FSs are prepared, in all material respects, in accordance with AFRF.;</li> <li>• Management is responsible for design, implementation and maintenance of IC and preparation and presentation of the FS as per AFRF.</li> </ul>
Q15.	<p>_____ refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. (a) Misstatement (b) Error (c) Fraud (d) Any of the above <b>(Sample MCQs) (ICAI MCQs) (MTP2, May 2019, 1 Mark) (MTP1, Nov 2019, 1 Mark)</b></p>
	<p><b>Correct answer:</b> (a) Misstatement <b>Explanation:</b></p>

	<ul style="list-style-type: none"> <li>• Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements in the financial statements can arise from either fraud or error.</li> <li>• Fraud can be committed by anyone such as management, TCWG, employees and third parties. Such an act has been committed using unfair means and is an intentional activity (deliberate action) to gain personal benefit directly or indirectly illegally. While errors are acts of unintentional mistakes or negligence which can be detected easily.</li> </ul>
Q16.	<p>One of your junior audit team members is confused with the term 'material misstatement'. You explain to him that a material misstatement is untrue information in a financial statement that could affect the financial decisions of one who relies on the statement. Which of the following would constitute material misstatement?</p> <p>(1) An error of ₹ 5,000 in relation to assets of ₹ 20 lakhs.  (2) A payroll fraud of ₹100 in a company where profit before tax is ₹11,000.  (3) Non-disclosure of a material uncertainty.  (4) Financial statements have been prepared on a going concern basis when the company is in the process of being liquidated.</p> <p>(a) 1 and 2  (b) 3 and 4  (c) 2 and 3  (d) 1 and 4</p> <p><b>(MTP2, May 2019, 2 Marks)</b></p>
	<p><b>Correct answer:</b> (b) 3 and 4</p> <p><b>Explanation:</b></p> <ul style="list-style-type: none"> <li>• An error of ₹ 5,000 i.e. an unintentional mistake in the financial information does not constitute a material misstatement. Payroll fraud of ₹ 100 is immaterial.</li> <li>• However, Non-disclosure of a material uncertainty and financial statements have been prepared on a going concern basis when the company is in the process of being liquidated would constitute material misstatement as such misstatements can impact the economic decisions of the users of the financial statements.</li> <li>• A material misstatement is information in the financial statements that is sufficiently incorrect that it may impact the economic decisions of the users of the financial statements.</li> <li>• There are some factors that can be considered while deciding if a misstatement is material or not. Factors are: the comparative size of the misstatement, the nature of the misstatement, the relationship to other misstatements, the inherent character of the mistake.</li> </ul>
Q17.	<p>Which of the following is correct :</p> <p>(a) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.  (b) The auditor is expected to and can reduce audit risk to zero and can therefore obtain absolute assurance.  (c) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.  (d) The auditor is expected to and can reduce audit risk to zero and can therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.</p> <p><b>(MTP2, May 2019, 1 Mark)</b></p>
	<p><b>Correct answer:</b> (a) the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.</p>
Q18.	<p>M/s KYC &amp; Co. is a reputed Audit firm in Mumbai. They are appointed as Statutory Auditors of Blessed Ltd. Which of the below is the responsibility of M/s KYC &amp; Co.</p> <p>(a) Preparation of financial statements  (b) Designing, implementation and maintenance of internal control system  (c) Reporting on true and fair view of financial statements  (d) Compliance with the applicable law and regulation</p> <p><b>(RTP, Nov 2020, NA)</b></p>

	<p><b>Correct answer :</b> (c) Reporting on true and fair view of financial statements</p> <p><b>Explanation:</b> The responsibility of M/s KYC &amp; Co. i.e. audit firm is to express opinion as to whether the financial statements exhibit a true and fair view of the affairs of the entity. The management is responsible for preparation of financial statements, designing, implementation and maintenance of internal control systems and compliance with the applicable law and regulation.</p>
Q19.	<p>The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are :</p> <p>(a) Management (b) those charged with governance (c) audit committee (d) board of directors</p> <p><b>(RTP, May 2021, NA) (MTP1, May 2021, 1 Mark ) (RTP, Nov 2021, NA) (RTP, Nov 2023, NA) (MTP2, Nov 2023, 1 mark)</b></p>
	<p><b>Correct answer:</b> (b) those charged with governance</p> <p><b>Explanation:</b></p> <ul style="list-style-type: none"> <li>• Management : The person(s) with executive responsibility for the conduct of the entity's operations. Management is responsible for the day to day work and implementing the policies framed by TCWG.</li> <li>• Those charged with governance: TCWG are responsible for strategic decisions. TCWG supervises the work done by the management and is responsible for approving the financial statements. TCWG is a higher authority. For example - Board of Directors, corporate trustee</li> <li>• Management and TCWG can be the same in some entities, say in small organisations.</li> </ul>
Q20.	<p>_____refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.</p> <p>(a) Assertions (b) Positive Confirmation (c) Written representation (d) Audit Evidence.</p> <p><b>(MTP1, May 2021, 1 Mark)</b></p>
	<p><b>Correct answer:</b> (a) Assertion</p> <p><b>Explanation:</b> Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur</p>
Q21.	<p>Owing to the _____ limitations of an audit, there is _____ risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.</p> <p>(a) Inherent, unavoidable (b) Inherent, complete (c) Management, unavoidable (d) Regulatory, control</p> <p><b>(MTP1, May 2022, 1 mark)</b></p>
	<p><b>Correct answer:</b> (a) Inherent, unavoidable</p>
Q22.	<p>Consider the following statements pertaining to nature and meaning of "assertions":-</p> <p>Statement I: Assertions are representations by the management which are present in financial statements.</p> <p>Statement II : The assertions have to be necessarily explicit.</p> <p>Which of the following is correct?</p> <p>(a) Only Statement I is true. (b) Only Statement II is true. (c) Both statements I and II are true. (d) Both statements I and II are false.</p> <p><b>(MTP1, May 2022, 1 mark)</b></p>

**Correct answer:** (a) Only Statement I is true.

**Explanation:** Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur

- Q23. With respect to auditing, which of the following statement is correct:
- (a) Audited financial statements are absolutely free from all material misstatement due to fraud or error.
- (b) An audit is an official investigation into alleged wrongdoing and auditor has specific legal powers to conduct investigation
- (c) The auditor can obtain only a reasonable assurance about whether the financial statement as a whole are free from material misstatement and report on it.
- (d) An auditor's opinion is an assurance as the future viability of the enterprise or the efficiency or effectiveness of the management.
- (MTP2, May 2023, 1 mark)**

**Correct answer:** (c) The auditor can obtain only a reasonable assurance about whether the financial statement as a whole are free from material misstatement and report on it.

**Explanation:**

- Statement 1 is incorrect as Audited financial statements are not absolutely free from all material misstatement due to fraud or error. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit.
- Statement 2 is incorrect as an audit is not an official investigation into alleged wrongdoing and the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.
- Statement 4 is incorrect as the user should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

- Q24. Consider the following data appearing in financial statements of a firm: -

Particular	Amount in Rs	Amount in Rs
Machinery (at cost)	XXX	10,00,000
Less: Depreciation of earlier years	6,00,000	XXX
Less: Depreciation of year	60,000	6,60,000
WDV at end of year	XXX	3,40,000

Read the following statements on basis of above: -

- The firm owns machinery.
- The machinery is being utilized in business of firm productively.
- The machinery physically exists.

Which of following would be obvious assertions on the basis of above data?

- (a) Only assertions (i) and (ii) can be inferred.
- (b) Only assertions (ii) and (iii) can be inferred.
- (c) Only assertions (i) and (iii) can be inferred.
- (d) All assertions (i), (ii) and (iii) can be inferred.

**(MTP2, Nov 2022, 1 Mark)**

**Correct answer:** (d) All assertions (i), (ii) and (iii) can be inferred.

**Explanation:** The assertions are as follows

- the firm owns the machinery;
- the historical cost of plant and machinery is ₹ 10 lacs;
- the machinery physically exists;
- the asset is being utilized in the business of the company productively;
- total charge of depreciation on this asset is ₹ 6,60,000 to date on which ₹ 60,000 relates to the year in respect of which the accounts are drawn up; and

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- |  |  |
|--|--|
|  | <ul style="list-style-type: none"><li>• the amount of depreciation has been calculated on a recognised basis and the calculation is correct.</li><li>• The above assertions are implicit</li></ul> |
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