

PART I - DESCRIPTIVE QUESTIONS

3.1 - Audit Risk (SA 315)

- Q.1 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.

Ans.: Inherent, control and detection risks:

- (a) **Inherent Risk:** Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.
- (b) **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 there and risk to auditor would again be that inventory records would be inaccurate.
- (c) **Detection Risk:** Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, 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.

- Q.2 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

Ans.: Audit risk:

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.

- Q.3 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?

Ans.: Component of RoMM:

Facts given in the question highlights 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.

Conclusion: Component of RoMM involved is "inherent risk."

Q.4 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 risk of material misstatement involved as an auditor of the company.

Ans.: Component of RoMM:

Facts given in the question highlights that 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.

Conclusion: Component of RoMM involved is "control risk".

Q.5 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?

Ans.: Detection Risk:

Facts given in the question highlights that there is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition.

Conclusion: The risk alluded to it is detection risk.

Q.6 Jojo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jojo Limited, identify any one reason of increased audit risk due to listing of the company next year.

Ans.: Reason of increased audit risk due to listing:

Based on the facts given in the question, 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 F.S. so that good response is received to proposed issue.

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

Q.7 On perusing financial statements of Jojo 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?

Ans.: Risk Assessment Procedure:

Facts given in the question highlights that 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.

Conclusion: Auditor is using "analytical procedures".

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

Ans.: Use of Analytical Procedures as Risk Assessment procedures:

- Analytical procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing RoMM in order to provide a basis for designing and implementing responses to the assessed risks.
- Analytical procedures may include both financial and non-financial information.
- Analytical procedures may help identify 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 RoMM, especially RoMM due to fraud.

Q.9 "Risk of material misstatement consists of two components". Explain clearly defining risk of material misstatement.

Ans.: Components of risk of material misstatement:

RoMM 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.

- (a) **Inherent Risk:** Susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, assuming that there were no related internal controls.
- (b) **Control Risk:** 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.

Q.10 "The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". Explain.

Ans.: Combined Assessment of RoMM:

- SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "RoMM". However, auditor may make separate or combined assessments of inherent and control risk depending on audit techniques or methodologies and practical considerations.
- Assessment of RoMM may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms.

Audit risk = Risks of material misstatement × Detection risk

Audit risk = Inherent risk × Control risk × Detection risk

Q.11 Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls. [RTP-May 18]

Ans.: Risk Assessment procedure:

SA 315 "Identifying and Assessing Risk of Material Misstatements through understanding the Entity and its Environment" defines the term Risk Assessment Procedure as 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.

Risk Assessment Procedures includes the following:

- ~~1. Inquiries of management, and of others within the entity:~~ Much of the information is obtained by the auditor through inquiry from management and others. 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.
- ~~2. Analytical procedures:~~ 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.
- ~~3. Observation and inspection:~~ Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

Q.12 The assessment of risks is a matter of professional judgment. Explain stating clearly what is not included in Audit Risk? [MTP-Aug. 18]

Ans.: Assessment of Audit Risk:

- Audit Risk is 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 is a function of ROMM and detection risk. Assessment of risks is based on audit procedures performed to obtain information necessary for that purpose and evidence obtained throughout the audit.
- Assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement. Professional judgment exercised by an auditor is based on his training, knowledge and experience.

~~Risks not forming part of Audit Risk:~~

- 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.
- 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.

Q.13 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. [RTP-Nov. 19]

Ans.: Combined Assessment of RoMM:

- SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "RoMM". However, auditor may make separate or combined assessments of inherent and control risk depending on audit techniques or methodologies and practical considerations.
- Assessment of RoMM may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms.

Audit risk = Risks of material misstatement × Detection risk

Audit risk = Inherent risk × Control risk × Detection risk

Q.14

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The risks of material misstatement may exist at the financial statement level and assertion level. Explain the two levels. [RTP-Nov. 20]

Ans.: Risk of Material Misstatement:

The risks of material misstatement may exist at two levels:

Potentially Affect many Assertions.

that relate pervasively to the FS as a whole.

- (i) **The overall financial statement level:** Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
- (ii) **The assertion level for classes of transactions, account balances, and disclosures:** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

Q.15

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. 20]

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. [MTP-Sep. 22]

Ans.: Identifying and assessing the risks of material misstatement:

- The auditor shall identify and assess the risks of material misstatement at:
 - (A) the financial statement level;
 - (B) the assertion level for classes of transactions, account balances, and disclosures 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:
 - (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
 - (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
 - (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
 - (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

① Identify
② Assess the identified risks.

Q.16

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. 20]

Or

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.

[MTP-Sep. 22]

Explain giving at least three examples.

Ans.: Inquiries of management, and of others within the entity:

Much of the information is obtained through inquiry from management and those responsible for financial reporting. However, auditor may also obtain information through inquiries of others within the entity & employees.

Example of Inquiries:

- (a) Inquiries directed toward internal audit personnel: may provide information about internal audit procedures performed relating to design & effectiveness of entity's internal control.
- (b) Inquiries of employees involved in initiating, processing or recording complex or unusual transactions: may help auditor to evaluate appropriateness of selection & application of accounting policies.
- (c) Inquiries directed toward in-house legal counsel: may provide information about matters such as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud.
- (d) 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.
- (e) Inquiries directed to the risk management function: may provide information about operational and regulatory risks that may affect financial reporting.
- (f) Inquiries directed to information systems personnel: may provide information about system changes, system or control failures, or other information system-related risks.

Q.17 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. 20]

Ans.: Use of Analytical Procedures as Risk Assessment Procedures:

- Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.
- Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.
- Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Q.18 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.

[July 21 (3 Marks)]

Ans.: Examples of audit procedures which include observation or inspection of entity's operations:

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

Examples of such audit procedures include observation or inspection of the following:

(RED)

(1) Entity's operations.

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

(3) Reports prepared by management (Quarterly Management Reports and Interim F.S.) & TCWG (Minutes of Board Meetings).

(4) Entity's premises and plant facilities.

Q.19 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.

[May 23 (4 Marks)]

Ans.: Audit Risk:

- Risk that auditor gives an inappropriate audit opinion when F.S. are materially misstated. It is the possibility that auditor expresses an unmodified opinion even when F.S. are materially misstated.
- Auditor is required to plan and perform audit in such a way that audit risk is reduced to an acceptably low level. SA 200 states that auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.
- Audit risk is a function of the risks of material misstatement and detection risk.

Risks not forming part of Audit Risk: Refer Answer of Q. No. 12.

3.2 SA 320 "Materiality in Planning and Performing an Audit"

Q.20 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.

Ans.: Consideration of Materiality and Audit Risk:

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.

Q.21 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.

Ans.: Consideration of Materiality:

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.

Q.22 Is materiality required to be documented by the auditor? What factors have to be considered this regard?

Ans.: Documentation of Materiality:

Audit documentation shall include the following amounts and the factors considered in their determination. **SMMLP3**

- (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) to (c) as the audit progressed.

Q.23 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 22]

Ans.: Audit Risk and Materiality:

- In conducting an audit of F.S., overall objectives of auditor are to obtain reasonable assurance about whether the F.S. 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 F.S. are prepared, in all material respects, in accordance with an applicable FRF; and to report on the F.S., and communicate as required by SAs, in accordance with auditor's findings.
- Auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.
- Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.
- Materiality and audit risk are considered throughout the audit, in particular, when:
 - (a) Identifying and assessing the risks of material misstatement;
 - (b) Determining the nature, timing and extent of further audit procedures; and
 - (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Q.24 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. [MTP-Oct. 19]

Ans.: Revision as the Audit Progresses

- SA 320 on "Materiality in Planning and Performing an Audit" lays down the standard on the concept of materiality.
- Materiality for the F.S. as a whole (and, if applicable, materiality levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a:
 - (a) change in circumstances that occurred during audit (for example, a decision to dispose of a major part of the entity's business),
 - (b) new information, or
 - (c) change in auditor's understanding of the entity and its operations as a result of performing further audit procedures.

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

Q.25 With reference 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. [Nov. 20 (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 22]

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. [May 23 (3 Marks)]

Ans.: Factors affecting identification of appropriate benchmark as per SA 320:

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:

- ✓ (1) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- (2) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- ✓ (3) 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;
- (4) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- ✓ (5) The relative volatility of the benchmark.

Q.26 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 21]

Ans.: Auditor's assumptions about users of the financial statements:

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

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

Q.27 Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain. [RTP-May 21]

Ans.: Concept of materiality in the context of the preparation and presentation of F.S.:

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

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

Q.28 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. 21]

Ans.: Concept of Materiality:

- SA 320 "Materiality in Planning and Performing an Audit" requires the auditor to 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 ₹ 5,00,000 may not be material for a large entity.