CA INTERMEDIATE

# Updated Sheet on Auditing & Ethics Descriptive Questions

AS PER NEW ICAI SYLLABUS

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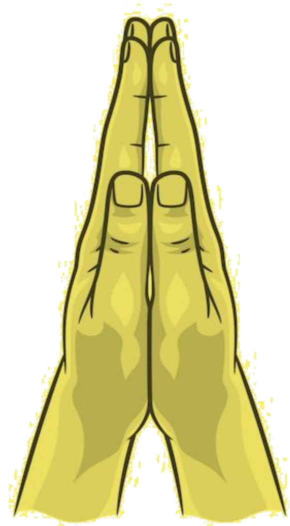

**DEDICATED**

**To My Parents**

***for raising me to believe that anything was possible***

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Happy Learning and all the best!!

# Chapter- 1: Nature, Objective and Scope of Audit

**Q-9: RST Ltd., a retail company, has set up internal controls requiring all invoices to be stamped and signed by an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises to ensure that only those purchase bills are produced for payment for which goods have been actually received.**

**During the audit, the auditor finds that two employees – a purchasing manager and an accounts clerk – have worked together to bypass this control, submitting fake invoices that resulted in payments for goods that were never received. You are required to state the objectives of an audit, as per SA 200, when it comes to ensuring the reliability of financial statements? Also explain, why auditor can provide only reasonable, rather than absolute, assurance that the financial statements are free from material misstatement due to fraud or error in the context of the given situation? [RTP Jan 2025]**

**Ans-9:** In conducting audit of financial statements, objectives of auditor in accordance with SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are: -

a. To obtain reasonable assurance about whether the financial statements 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 financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b. To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the factors such as nature of financial reporting nature of audit procedures, not in the nature of investigation, timeliness of financial reporting and decrease in relevance of information over time and future events.

Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, the auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors. One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

In the context of RST Ltd., the management designed a control requiring that all invoices be stamped and signed by an authorized person in the Goods Receiving Section to confirm receipt of goods. However, collusion between two employees—the purchasing manager and the accounts clerk—allowed them to bypass this control by submitting fake invoices for payment. Collusion is a significant limitation of internal controls, as it overrides controls designed to prevent such fraud.

Given these factors, the auditor cannot provide absolute assurance that the financial statements are entirely free from material misstatements due to fraud or error.

**Q-10: Kriti, a CA student, has joined articles in a reputed audit firm. She considers audit engagement to be an "assurance engagement". Her understanding is that audit engagement is the only kind of assurance engagement in which practitioner gives a written assurance report in appropriate form. However, her friend Somaya, does not agree with her. She is of the view that assurance engagements are not restricted to audit alone. Besides, Somaya also thinks that assurance engagements can also relate to matters other than historical financial information. Whose view appears to be correct? State with reasons. (RTP SEP 2024)**

**Ans-10:** Audit engagement is an assurance engagement. However, assurance engagements are not restricted to auditing alone. There are other assurance engagements too like review engagements, engagements providing assurance involving prospective financial information, engagements providing assurance on internal controls in an entity. Assurance engagements provide assurance to users. The difference is of degree. Whereas an audit provides reasonable assurance which is a high level of assurance, review provides lower level of assurance as compared to audit.

There are also assurance engagements which relate to matters other than historical financial information like providing assurance on matters involving prospective financial information and providing assurance on internal controls in an entity. In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions, and it is properly presented, and all material assumptions are adequately disclosed.

In the given case, Kriti is of the view that audit engagement is the only kind of assurance engagement in which practitioner gives a written assurance report in appropriate form whereas is of the view that assurance engagements are not restricted to audit alone. Thus, view of Somaya is correct.

**Q-11: Mr. J is an articled clerk with a big Chartered Accountants' firm. He is a part of the engagement team which is conducting the audit of a company for the first time. They are assigned with the work of preparing the draft audit engagement letter. Mr. J is not sure how to go about with this work. Explain what is Audit Engagement Letter and what are its contents? (PYQ SEP 2024)**

**Ans-11:** Audit Engagement Letter: The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement are recorded in a letter or other the suitable form of written agreement. Such an agreement is known as Audit Engagement Letter. The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

Audit Engagement letter includes: -

(1) The objective and scope of the audit of the financial statements

(2) The responsibilities of the auditor

(3) The responsibilities of management

(4) Identification of the applicable financial reporting framework for the preparation of the financial statements and

(5) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies, and that management acknowledges and understands its responsibilities.

**Q-12: JK Ltd. was having a 'Pager' manufacturing plant and looking at the demand it was of the view that the company will grow continuously in future. But, with the introduction of mobile phones in the market, the plant was shut down completely. The shareholders of the company were of the view that auditor failed to perform their duty and have not informed to them about the company's inability to continue its business, otherwise they might not have suffered the loss. List down the factors giving rise to the inherent limitations due to which auditor cannot provide a guarantee that the financial statements are free from material misstatement due to fraud or error.** **(RTP SEP 2024)**

**Ans-12:** Inherent limitations of audit: The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the following factors: -

I. Nature of financial reporting: Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

II. Nature of Audit procedures: The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence. Further, fraud may involve sophisticated and carefully organized schemes.

III. Not in nature of investigation: Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

IV. Timeliness of financial reporting and decrease in relevance of information over time: The relevance of information decreases over time and auditor cannot verify each and every matter. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.

V. Future events: Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

**Q-13: Rajul Ltd. engaged an external practitioner CA Rajul to provide assurance on its prospective financial information for the upcoming year, which includes projections for a new product line. The company projected a 15% increase in revenue, estimating total sales of Rs.75 crore, driven by the expected launch of this new product. Mention the applicable Engagement and Quality Control Standard and the level of assurance that will be provided in the given situation. Also explain how Prospective Financial Information is different from Historical Financial Information. [MTP JAN 2025]**

**Ans-13:** In the given situation, Standards on Assurance Engagements will be applicable and such type of assurance engagement provides only a "moderate" level of assurance.

In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions and it is properly presented and all material assumptions are adequately disclosed.

"Historical financial information" and "Prospective financial information." The former relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The latter relates to financial information based on assumptions about occurrence of future events and possible actions by an entity. Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

**Q-14: RST Ltd., a mid-sized trading company, recently faced challenges in securing a bank loan due to doubts about the reliability of its financial statements. The management realised the importance of having audited accounts to build confidence among lenders and other stakeholders. Elucidate the benefits and need of an audit. [MTP JAN 2025]**

**Ans-14:** Benefits and need of Audit:

- Audited accounts provide high quality information. It gives confidence to users 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.
- In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
- An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit.
- Audited financial statements are helpful to government authorities for determining tax liabilities.
- Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.

## Chapter-2: Audit Strategy, Audit Planning and Audit Programme

**Q-18: During the audit of ABC Ltd., a medium-sized manufacturing company, the engagement partner is responsible for directing and supervising the work of the engagement team. The team includes both experienced members and several new trainees. Additionally, certain areas of the audit have been identified as high-risk, such as revenue recognition and inventory valuation, due to recent changes in ABC Ltd.'s accounting policies. What factors should the engagement team members consider when determining the nature, timing, and extent of direction, supervision, and review of the engagement team's work?**

**(RTP JAN 2025)**

**Ans-18:** The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including: -

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement
4. The capabilities and competence of the individual team members performing the audit work.

**Q-19: CA N, engagement partner of LPS & Associates, is planning for audit of a large company. As part of preliminary engagement activities being performed in this regard, he wants to ensure that compliance with independence requirements is adhered. How shall he form a conclusion that audit firm complies with independence requirements? (RTP SEP 2024)**

**Ans-19:** The engagement partner, CA N shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, CA N shall: -

i. Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence

ii. Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and

iii. Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

**Q-20: The engagement partner, of a firm of auditors, is explaining to his audit team, undergoing practical training, the inter relationship between audit strategy and audit plan. Discuss the points which the engagement partner will explain to his team in this regard. (PYQ SEP 2024)**

**Ans-20:** Relationship between audit strategy and audit plan

- Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy.
- Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented.
- The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.
- Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.
- The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in consequential changes to the other.

**Q-21: EFG Ltd. has appointed M/s. MN & Co., Chartered Accountants, as the statutory auditors for the year 2024-25. CA N, the engagement partner, completed his risk assessment procedure. However, he is concerned about the management of human resources to be employed to conduct the audit. For this purpose, he wants to establish an overall audit strategy for setting the scope, timing and direction of the audit. Describe how the process of establishment of overall audit strategy will assist him in managing deployment of his human resources for various audit areas. (PYQ SEP 2024)**

**Ans-21:** Establishing the overall audit strategy- Assistance for the auditor : Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

i. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters.

ii. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.

iii. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates.

iv. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

**Q-22: M/s. PP & Co, a firm of Chartered Accountants, has been auditing the books of accounts of KALI Ltd. for the past 3 years. The company has recently made some major changes in its business policies. While planning to start the audit for the 4th year i.e. for financial year 2024-25, the audit manager of the firm, as per the routine practice, handed over the previous years' audit**

**programme as it is to the audit team with the instructions to adhere unfailingly to the said audit programme. Evaluate the decision of the audit manager with reference to the use of audit programme. (PYQ SEP 2024)**

**Ans-22:** Review of the audit programme: There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed.

Audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

In the given situation, Ms. PP & Co., a firm of Chartered Accountants has been auditing the books of accounts of KALI Ltd. for the past 3 years and the Company has recently made major changes in its business policies, therefore, it is very essential to review the audit programme. Thus, contention of the audit manager to adhere with the instructions of following the same audit programme as per routine practice is not correct.

**Q-23: APR & Associates, a Chartered Accountant firm, are appointed as the auditors of Time Ltd. and Bakes Ltd. The volume and nature of business of both the companies are entirely different. CA R is the engagement partner for Bakes Ltd. CA P is the engagement partner for Time Ltd. CA R formulates an Audit**

**Programme for conducting the audit of Bakes Ltd. He suggests CA P to use the same audit programme for Time Ltd. But CA P is of the opinion that this audit programme will not be useful for the audit of Time Ltd.**

**In light of the above, mention the matters that should generally be considered while preparing an Audit Programme. Is CA P correct in emphasizing for a different Audit Programme for Time Ltd.? (PYQ SEP 2024)**

**Ans-23:** Following matters should be considered generally while preparing an Audit Programme:

(1) Stay within the scope and limitation of the assignment.

(2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.

(3) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

(4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(5) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.

(6) Consider all possibilities of error.

(7) Co-ordinate the procedures to be applied to related items.

Evolving one audit programme- Not Practicable for All businesses: Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.

In view of above mentioned provisions, CA. P is correct in emphasizing for a different audit programme for Time Ltd.

**Q-24: B Ltd. is a company manufacturing bed-sheets and pillow covers. They have appointed M/s C & Co., Chartered Accountants, as their auditors. The auditor is establishing audit strategy with his team members. As the work progressed, they came to know that the company has diversified its business and now they are also planning to manufacture wooden furniture. The auditor, in his professional judgement, considers this to be a significant factor in directing the engagement team's efforts. Give examples of factors that, in auditor's professional judgement, are significant in directing the engagement team's efforts.** (PYQ MAY 2024)

**Ans-24:** Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts: The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Few examples are listed as under: -

(i) Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control.

(ii) Significant industry developments such as changes in industry regulations and new reporting requirements.

(iii) Significant changes in the financial reporting framework, such as changes in accounting standards.

(iv) Other significant relevant developments, such as changes in the legal environment affecting the entity.

**Q-25: CA E is auditor of LM Ltd. Before commencing with current year's audit, he initiated planning for the audit. Planning includes the need to consider certain matters, prior to the identification and assessment of the risk of material misstatements. Enumerate such matters.** (PYQ SEP 2024)

**Ans-25:** Nature of Audit Planning- A Continuous and iterative process: Planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as: -

1. The analytical procedures to be applied as risk assessment procedures.

2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

3. The determination of materiality.

4. The involvement of experts.

5. The performance of other risk assessment procedures.

**Q-26: Lotus Ltd., a rapidly growing manufacturing company, appointed Ridhi & Co., as statutory auditor. The engagement team of Ridhi & Co. identified key areas requiring scrutiny, such as revenue recognition, inventory valuation, and related party transactions. Based on his professional judgment, CA Ravi, the engagement partner, directed the engagement team to focus on these critical areas, emphasising the need for detailed testing to ensure accuracy and compliance. Give some examples of the factors need to be considered by CA Ravi for establishing the audit strategy. (MTP JAN 2025)**

**Ans-26: Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.**

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More attention need to be devoted to significant matters to obtain desired outcomes.

Examples of the factors that need to be considered by CA Ravi for establishing audit strategy are: -

- Volume of transactions which may determine whether it is more efficient for the auditor to rely on internal control.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal

environment affecting the entity.

**Q-27: Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions apparent in the statements of account produced for audit or based on an appraisal of the accounting records of the client. For example, while auditing a company's inventory, the program may include steps to verify physical stock counts, ownership rights, and valuation. What are the advantages of an audit programme? (MTP JAN 2025)**

**Ans-27: The advantages of an audit programme are:**

- It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a risk of ignoring or overlooking certain books and records. Under a properly framed programme, such risk is significantly less and the audit can proceed systematically.
- The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- It serves as a guide for audits to be carried out in the succeeding year.
- A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

**Q-28: "In establishing the overall audit strategy, the auditor shall, among other considerations, ascertain the nature, timing and extent of resources necessary to perform the engagement". Explain those considerations in detail. (MTP JAN 2025)**

**Ans-28:** In establishing the overall audit strategy, the auditor shall:

(i) Identify the characteristics of the engagement that define its scope;

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

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

(iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

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

**Q-29: The engagement partner, of a firm of auditors, is explaining to his audit team, undergoing practical training, the inter relationship between audit strategy and audit plan. Discuss the points which the engagement partner will explain to his team in this regard. (MTP JAN 2025)**

**Ans-29: Relationship between audit strategy and audit plan:**

- Audit strategy sets the broad overall approach to the audit whereas audit plan addresses the various matters identified in the overall audit strategy.
- Audit strategy determines scope, timing and direction of audit. Audit plan describes how strategy is going to be implemented.
- The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.
- Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through

the efficient use of the auditor's resources.

- The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in consequential changes to the other.

# Chapter-3: Risk Assessment and Internal Control

**Q-23: The auditor of EFG Ltd., a company engaged in the Tours & Travel business, needs to obtain an understanding of the company's control environment. To do this, the auditor evaluates whether**

(i) **Management has created and maintained a culture of honesty and ethical behaviour; and**

(ii) **The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control**

**What is included in control environment? Also explain the elements of control environment.** *(RTP Jan 2025)*

**Ans-23:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether

(i) Management has created and maintained a culture of honesty and ethical behaviour and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

**The control environment includes:**

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management.

(iii) the control environment sets the tone of an organization, influencing the control consciousness of its people.

**Elements of Control Environment**

Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

a. **Communication and enforcement of integrity and ethical values:** The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behaviour are the product of the entity's ethical and behavioural standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioural standards to personnel through policy statements and codes of conduct and by example.

b. **Commitment to competence:** Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

c. **Participation by those charged with governance:** It includes attributes of those charged with governance such as their independence from management, their experience and stature, the extent of their involvement and the information they receive and the scrutiny of activities.

d. **Management's philosophy and operating style:** Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions towards financial reporting- what approach is taken by management in selecting accounting policies, approach in developing accounting estimates etc. Matters such as approach of management to taking and managing business risks, management's attitude towards information processing and accounting function and personnel reflects upon management's philosophy and operating style.

e. **Organisational structure:** The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed. Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities.

f. **Assignment of authority and responsibility:** Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

g. **Human resource policies and practices :**Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity.

**Q-24: Companies are increasingly using data analytics for managing their operations. Auditors can also obtain good results by using data analytics. What are the tools and techniques used by auditors in applying the principles of Data Analytics and in which areas data analytics can be used by auditors? (RTP SEP 2024)**

**Ans-24:** The tools and techniques that auditors use in applying principles of data analytics are known as Computer Assisted Auditing Techniques (CAATs).

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following: -

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

**Q-25: CA B, was the auditor of Star Limited. He wanted to ensure that the company had correctly reconciled its bank accounts and also wanted to understand whether and how far the internal control system was operating in the company. What kind of test of control was CA B performing? What are the other procedures that can be applied while undertaking test of controls?**

**(PYQ SEP 2024)**

**Ans-25:** Inquiries of Management and Others Within the Entity: After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. Test of controls are performed to obtain audit evidence about the effectiveness of the: -

i. Design of the accounting and internal control system

ii. Operation of the internal control throughout the period

In the given case, CA B was performing Re-performance. It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

Other procedures that can be applied while undertaking test of controls are:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

**Q-26: CA Amit is the auditor of LMN Ltd. While conducting the audit, he wanted to analyze the different components of internal control of the company. Identify and explain which component of internal control he is trying to understand in the following two cases: -**

**(i) Whether controls in LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions.**

**(ii) Whether there exists proper segregation of duties in the company and the person responsible for recording a transaction is different from the person authorizing it.** **(PYQ SEP 2024)**

**Ans-26:**

i. In this case, CA. Amit is trying to understand that whether controls in the

LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions: He is gaining the understanding of the Monitoring of controls component of internal control. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

ii. In the given situation, CA Amit is trying to understand that whether there exists a proper system of segregation of duties in the company and the person responsible for recording a transaction is different from the person authorising it. He is gaining an understanding of internal control of the company. In particular, he is understanding "control activities". When a person recording a transaction is different from one authorizing it, he gains confidence that there exists a system for preventing misstatements. It helps him in gaining insight into the internal control system of the company.

**Q-27: Z and Associates are the auditors of Realton Ltd., an export oriented unit, which specializes in manufacturing oil extraction plants. Since many complex processes are involved, they are digitizing their operations. They are restructuring their business models which are driven by technology. Since most of the operations of the company are automated, Z and Associates are planning to do Digital Audit. Explain the use of digital technology in the conduct of an audit. (PYQ SEP 2024)**

**Ans-27:** Use of Digital Technology in the conduct of an audit: Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization.

In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.

- Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.

- By using such tools, auditors can conduct audits in a better way and devote more attention to areas requiring greater focus.
- Digital audit is helping auditors to better identify risks making use of technology.

**Q-28: You are appointed as the auditor of a company manufacturing paints. The company has a robust system of internal control. Most of the controls in the company are automated and they are working effectively. However, in certain situations, manual elements in internal controls are more suitable. What are the circumstances where manual elements in internal controls may be more suitable? (PYQ MAY 2024)**

**Ans-28:** Manual elements vs automated elements in entity's internal control: Manual elements in internal control may be more suitable in the following circumstances:

- Where judgment and discretion are required.
- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

**Q-29: Mr. D an auditor, while auditing ACE Ltd., identified certain misstatements in relation to particular class of transactions and account balances. He had communicated same to those charged with governance and also taken written representation for the same. State the audit documentation required by the auditor regarding misstatements identified during the audit.**

**(PYQ MAY 2024)**

**Ans-29:** Documentation regarding misstatements identified during audit: The audit documentation shall include:

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

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

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

**Q-30: CA Srishti, while auditing KSM Private Limited for the first time, utilised software to analyse financial data, comparing amounts recorded in the financial statements for the current audit year with the preceding two years. Her objective was to evaluate the risk of material misstatement.**

**Identify the type of audit procedure performed by CA Srishti in the given case, discuss its relevance, and explain whether an auditor's opinion can solely rely on such procedures. (MTP JAN 2025)**

**Ans-30:** In the given case, CA Srishti is performing 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.

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.

Risk assessment procedures are a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.
Thus, it can be concluded that auditor's opinion cannot be solely based upon such procedures.

**Q-31: SA 330 states that auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to operating effectiveness of**

**relevant controls. Briefly discuss when such tests are to be designed and performed in accordance with SA 330?**

**If an auditor intends to place greater reliance on effectiveness of a control, state its likely effect on audit evidence to be obtained as a result of such tests of controls. Why a higher level of assurance may be sought by an auditor about the operating effectiveness of controls? (MTP JAN 205)**

**Ans-31:** The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when: -

(i) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures) or

(ii) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence, the greater the reliance the auditor places on the effectiveness of a control.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular, where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

**Q-32: KR & Associates, an auditor of FDP Ltd., observed that the company has implemented various internal controls addressing financial reporting, operational efficiency, and compliances during their preliminary evaluation. CA Karan suggests that all controls should be assessed to mitigate the risk of material misstatement in the financial statements, while CA Rajat is of the view that only those controls deemed relevant to the audit should be assessed based on professional judgment.**

**Comment, whether the auditor should assess all the internal controls or limit the assessment to only those considered relevant by the auditor during the audit. Also, discuss the factors influencing the auditor's judgment on the relevance of controls. (MTP JAN 2025)**

**Ans-32:** There is a direct relationship between an entity's objectives and the control it implements to provide reasonable assurance about their achievement. FDP Ltd. has implemented internal controls addressing financial reporting, operational efficiency, and compliance. However, not all of these objectives and controls are relevant to the auditor's risk assessment.

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

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

In the given case, CA Karan suggests that all controls should be assessed to mitigate the risk of material misstatement in the financial statements, while CA Rajat is of the view that only those controls deemed relevant to the audit should be assessed based on professional judgment.

Based on the factors mentioned above, it can be concluded that the auditors should assess only those controls deemed relevant to mitigate the risk of material misstatement in FDP Ltd.'s financial statements.

**Q-33: Calen Retail Ltd. is preparing its annual financial statements, and the auditors are tasked with determining materiality. The company has used revenue as the benchmark, as it is a key indicator of performance. However, Calen Retail has recently opened new stores and closed underperforming ones, which could**

**significantly affect both revenue and profitability. As per given case, what factors should the auditors consider when selecting the most appropriate benchmark for materiality?** **(MTP JAN 2025)**

**Ans-33:** Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements like assets, liabilities, equity, revenue, expenses.
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused. For example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates, the entity's ownership structure and the way it is financed. 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.
- The relative volatility of the benchmark.

**Q-34: When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls.** **(MTP JAN 2025)**

**Ans-34: Matters the auditor may consider in determining the extent of test of controls include the following:**

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.

- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.

The extent to which audit evidence is obtained from tests of other controls related to the assertion.

**Q-35: Knowledge of the Client's business play an important role in developing an overall audit. In fact, without adequate knowledge of the client's business, a proper audit is not possible. As per SA 315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Substantiate with the help of examples.** **(MTP JAN 2025)**

**Ans-35:** As per SA 315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.

- Examples of matters the auditor may consider include market and competition, whether entity is engaged in seasonal activities, product technology relating to the entity's products. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.
- Relevant regulatory factors include the regulatory environment. The regulatory environment includes, among other matters, the applicable financial reporting framework and the legal and political environment.
- Examples of matters the auditor may consider include accounting principles and industry specific practices, regulatory framework for a regulated industry, legislation and regulation that significantly affect the entity's operations, including direct supervisory activities, taxation, government policies currently affecting the conduct of the entity's business, environmental requirements affecting the industry and the entity's business.
- Examples of other external factors affecting the entity that the auditor may

consider include the general economic conditions, interest rates and availability of financing, and inflation etc.

# Chapter-4: Audit Evidence

**Q-37: CA Mukul is the external auditor of Beige Ltd., a large company, engaged in the manufacturing of fast-moving consumer (FMCG) goods. After assessing the internal audit function of the company, CA Mukul decided to use the internal auditor of the company to provide direct assistance. In this context, what is meant by direct assistance under relevant Standard on Auditing? Also comment whether prior to using internal auditor for direct assistance for the purpose of audit, CA Mukul is required to obtain any written agreements or not. Give examples of procedures in which CA Mukul shall not use an internal auditor to provide direct assistance. (JAN 2025)**

**Ans-37:** As per SA 610, "Using the work of Internal Auditor", direct assistance refers to the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

Prior to using internal auditors to provide direct assistance for purposes of the audit, CA Mukul, the external auditor shall: -

(a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and

(b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

Examples of procedures in which CA Mukul shall not use internal auditor to provide direct assistance to him are: -

(a) Procedures which involve making significant judgments in the audit;

(b) Procedures relating to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.

(c) Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(d) Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

**Q-38: Quality Products Limited is engaged in manufacturing of bicycles. As part of manufacturing activities, it sends raw material to some business entities and procures finished components from them. As on 31st March 2024 inventories lying with such business entities are material. Being statutory auditor of Quality Products Limited, how you will obtain sufficient appropriate audit evidence regarding existence and condition of inventories lying with such business entities? (RTP SEP 2024)**

**Ans-38:** In accordance with requirements of SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances.

**Other audit procedure may include –**

- Inspecting documentation regarding inventory held by third parties.
- Requesting confirmation from other parties when inventory has been pledged as collateral.
- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded

**Q-39: CA Rashmi is the auditor of ABC Ltd. for the financial year ending 31/03/2024. The audit report for the year was signed by her on 19/04/2024.**

**On 25/4/2024, the company received a communication from the Central Government that an incentive amount of Rs. 5 crores pertaining to financial year 2023-24 was approved. It was paid to the company before the end of April 2024. The financial statements of the company were not yet issued to the shareholders.**

**The Board of Directors wished to include the incentive amount in the financial statements and requested the auditor to issue a fresh audit report for the year ended 31/03/2024.**

**Analyze the issue involved and give an overview of the auditor's responsibility in such a situation. (PYQ SEP 2024)**

**Ans-39:** Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued: As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.

However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

(i) Discuss the matter with management and, where appropriate, those charged with governance.

(ii) Determine whether the financial statements need amendment and, if so,

(iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment.

Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

In the instant case, ABC Ltd. received an amount of ` 5 crore on account of incentives pertaining to year 2023-24 in the month of April 2024 i.e. after finalisation of financial statements and signing of audit report but before the issuance of Financial Statements to stakeholders. The Board of Directors of ABC Ltd. wished to amend the financial statements and requested the CA. Rashmi (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2024.

After applying the conditions given in SA 560, CA. Rashmi can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

**Q-40: Auditors cannot normally examine all the information available to them as it would be impracticable to do so and using audit sampling will produce valid conclusions. Samples should be selected in such a manner that it is representative of the population from which the sample is being selected.**

**Which sample selection method is used in the following two cases? Identify and explain them briefly.**

1. **Auditor divided the trade receivables in three groups: balances above Rs.20 lakhs, balances between Rs.10 lakhs to Rs.20 lakhs and balances below Rs.10 lakhs. He selected different percentages of items from each group.**
2. **Auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year.**

**Ans-40: Sample Selections Methods:**

i. Stratified Sampling method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

   In the given case, Auditor divided the trade receivables in three groups i.e. balances above Rs.20 lakhs, balances between Rs.10 lakhs to Rs.20 lakhs and balances below Rs. 10 lakhs and he selected different percentages of items from each group will be considered as Stratified Sampling.

ii. Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once.

In the given case, the auditor uses the sample of 50 consecutive cheques to test whether the cheques are signed by authorized signatories, rather than picking 50 single cheques throughout the year is Block Selection Method.

**Q-41: You are the statutory auditor of NP Ltd. Looking at the huge size of similar transactions, you directed your team members to use statistical sampling. One of the team members, Mr. Q, wants to select samples based upon his personal experience & knowledge as he is not aware of statistical sampling. You are required to explain to Mr. Q why the use of statistical sampling method is more scientific and appropriate. (PYQ SEP 2024)**

**Ans-41:** Statistical sampling: Statistical sampling is an approach to sampling that has the random selection of the sample units and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Statistical Sampling is more scientific and appropriate as:

- Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.
- Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of samples can be evaluated and projected on the whole population in a more reliable manner.

In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged.

**Q-42: The management of D. Ltd. have engaged an actuary-expert to ascertain actuarial valuation of gratuity for provision to be made in the accounts. As an auditor of D. Ltd., you plan to use the report of the said expert as audit**

**evidence for ascertaining appropriate valuation of provisions. As an auditor, what will you do to evaluate the competence, capabilities, objectivity and an understanding of the work of the actuary-expert who has carried out actuarial valuation of gratuity? (PYQ SEP 2024)**

**Ans-42:** As per SA 500, "Audit Evidence", issued by ICAI, when using the work of a management's expert as audit evidence the auditor should evaluate the competence, capabilities and objectivity of that expert that:

- Whether the expert is employed by the entity or is an outside party.
- Whether the expert is independent in respect of the entity.
- Auditor's previous experience of the work of the expert.
- Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.

The auditor should also obtain an understanding of the work of that expert that:

- Whether the auditor has expertise to evaluate the work of the expert.
- Evaluating the assumptions and methods used by the management.
- Evaluating the nature of internal or external data used by the expert.

**Q-43: During the audit of accounts for the year ended 31.03.2024, the auditor of FD Limited wanted confirmation from a Trade Receivable, which was outstanding for more than six months, amounting to Rs. 4,25,000/-. The auditor sent a Confirmation letter to the party requesting them to respond directly to him, whether or not they agree with the amount outstanding from them.**

**That trade receivable confirmed to the auditor of FD Limited, that they were required to pay an amount of Rs.4,20,000 to FD Limited as per their books of accounts.**

**State and explain the type of Confirmation Request sent by the auditor and the course of action that he should take on the confirmation received from the trade receivable. (PYQ SEP 2024)**

**Ans-43:** Positive confirmation request: A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request or providing the requested information.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party. The exception needs to be assessed to the entire population after analyzing the reason for difference.

In the given situation, the auditor has sent the positive confirmation request for the amount of 4,25,000 to a trade receivable which was outstanding for more than 6 months, however, due to difference between information requested to be confirmed, or contained in the entity's records (i.e. 4,25,000), and information provided by the confirming party (i.e. 4,20,000) is forming situation of exception confirmation.

The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330 in case a response is indicating an exception.

The company should be asked to investigate and reconcile the discrepancy indicated by the confirming party.

**Q-44: CA Q is the engagement partner for the audit of a Departmental store. As a part of the risk assessment procedure, he wants to make inquiries of the management and others within the entity. What kind of information can the auditor get by inquiring from the following?**

**(i) Internal audit personnel**

**(ii) In-house legal counsel**

**(iii) Marketing or sales personnel**

**(iv) Information systems personnel**

**Ans-44: Inquiries of Management and Others Within the Entity:**

I. Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.

II. Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract.

III. 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.

IV. Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

**Q-45: The management of PQ Ltd. changed during the period under audit. Mr. G an auditor, at the time of receiving written representation on the management responsibilities from the management, was in a dilemma related to the date of and period(s) covered by the written representation. Further, new management was of the view that they can give written representation from the date they took over and not for the prior period when old management were managing affairs of the company. Guide the auditor & the management in this respect.**

**Ans-45:** As per SA 580, "Written Representations", the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies. In view of above, management is required to provide the written representation for all the periods even when current management were not present during all periods referred to in the auditor's report.

**Q-46: M/s PSR & Associates are the auditors of The Saturn Hotel, a chain of five-star hotels. Since the nature of their business is prone to frauds, the company has appointed internal auditors at various locations. The company has also devised a system of effective and efficient internal controls. The auditors, M/s PSR & Associates, want to use the work of the internal auditors. In order to ensure effectiveness, what kind of coordination should be there between the external auditor and the internal audit function? (MAY 2024)**

**Ans-46:** As per SA 610, "Using the Work of Internal Auditors", coordination between the external auditor and the internal audit function is effective when, for example

I. Discussions take place at appropriate intervals throughout the period.

ii. The external auditor informs the internal audit function of significant matters that may affect the function.

iii. The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

**Q-47: M/s KLM & Co. Chartered Accountants, a partnership firm, while designing tests of controls and tests of details in MN Ltd. has to determine the items for testing that can be effective in meeting the purpose of the audit procedure. For this, they decided to select specific items from a population. State the factors that can be considered by the audit firm for selecting specific items from a population and also state the specific items that can be included for such testing.**

**Ans-47: The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include:**

a. the auditor's understanding of the entity,

b. the assessed risks of material misstatement, and

c. the characteristics of the population being tested.

Specific items selected may include

- High value or key items: The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.
- All items over a certain amount: The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- Items to obtain information: The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

**Q-48: XY and Associates are auditors of PQR Ltd., which provides electrical components on project basis. The purchases are huge and the auditor wants to make sure that all the purchases made during the period are recorded and there is no understatement or overstatement. For this purpose the audit team have performed procedures like cut-off tests, correct treatment of goods in transit, obtaining written representations and performing analytical procedures. What are the analytical procedures required to be performed to obtain audit evidence as to overall reasonableness of purchase quantity and price?**

**Ans-48: The auditor should perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:**

i. Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management, if any significant variations are found.

ii. Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.

iii. Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.

iv. Quantitative Reconciliation: Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

**Q-49: During the audit of a company, CA Jack obtained written representations from management regarding all known instances of non-compliance with laws and regulations that should be considered in the preparation of the financial statements. However, during the audit, he observed that the information provided in this regard was incomplete, and the audit evidence indicating such non-compliance contradicted the written representations, casting doubt on their reliability. How should CA Jack proceed in this situation? (MTP JAN 2025)**

**Ans-49:** In the given situation, company's management has not provided complete information regarding instances of non-compliance with laws & regulations. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.

The above situation highlights that auditor has obtained audit evidence relating to non-compliance with laws which is inconsistent with written representations in this respect casting a doubt about reliability of written representations.

As per SA 580, "Written Representation", if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report" having regard to the requirement of disclaimer of opinion.

**Q-50: CA Shubham, the auditor of Sigma Limited, is performing tests of controls and tests of details using audit sampling. During these procedures, he observed deviations in compliance with management's prescribed procedures for sales transactions of small values of a product at one location during tests of controls. Additionally, misstatements were identified in the sample related to these small-value sales transactions during tests of details. How should he proceed to analyse the nature and cause of the deviations and misstatements observed in the sample results? (MTP JAN 2025)**

**Ans-50:** In the given case, while performing tests of details on a sample in respect of sales, misstatements have been found by CA Shubham in selected sample pertaining to the sales transactions of small values. This indicates observance of deviations and misstatements while performing tests of controls and tests of details respectively in selected samples.

As per SA 530, "Audit Sampling", in analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.

In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.

Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

**Q-51: The reliability of audit evidence depends on its source, nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance. Although exceptions may exist, few generalisations can be made about reliability of audit evidence. Considering above discuss such**

**generalisations that can be made about the reliability of audit evidence.**

**(MTP JAN 2025)**

**Ans-51:** While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally
- Audit evidence obtained as original documents is more reliable than audit evidence obtained as photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form because in these cases the reliability of which may depend on the controls over their preparation and maintenance.

**Q-52: CA Rishi is appointed as an auditor of AIR Ltd. for the financial year ending on March 31, 2024. During the audit, he observed that the company's books of accounts reflect a significant number of trade payables and receivables as on the balance sheet date. To verify the accuracy of the trade receivables, CA Rishi decided to send confirmation requests to some of trade receivables. However, the management refused to permit him to send these confirmation requests to the selected parties. How should the auditor proceed in the given situation? (MTP JAN 2025)**

**Ans-52:** As per SA 505, "External Confirmation", If management refuses to allow the auditor to send a confirmation request, the auditor shall:

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

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

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

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

**Q-53: CA Kavita, auditor of Healthify Ltd., while assessing potential risks of material misstatement related to litigations at Healthify Ltd., identified a possible legal claim that could affect the financial statements. She sent a general inquiry letter to the company's external legal counsel, Mohit & Co., seeking clarification. However, Mohit & Co. informed her that their professional rules prohibited them from responding to these general inquiries. Guide CA Kavita that what other option is available to obtain the necessary information for the audit? (MTP JAN 2025)**

**Ans-53:** If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.

If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(i) A list of litigation and claims;

(ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(iii) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

**Q-54: The management of PQ Ltd. changed during the period under audit. Mr. Govind, an auditor, at the time of receiving written representation on the management responsibilities from the management, was in a dilemma related to the date of and period(s) covered by the written representation. Further, new management was of the view that they can give written representation from the date they took over and not for the prior period when old management were managing affairs of the company. Guide the auditor and the management in this respect. (JAN 2025)**

**Ans-54:** As per SA 580, "Written Representations", the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies. In view of above, management is required to provide the written representation for all the periods even when current management were not present during all periods referred to in the auditor's report.

# Chapter-5: Audit of Items of Financial Statements

**Question:** **During the audit of Rapid Industries Private Limited, CA Akshat notices that inventories of raw materials & consumables and work-in- progress amounting Rs.2.50 crores and Rs. 0.25 crores appear in the financial statements of the company as on March 31$^{st}$, 2024. He wants to verify that the above-mentioned inventories have been valued appropriately and as per generally accepted accounting policies and practices. How should he proceed to verify the above?** (RTP JAN 2025)

**Answer:** To verify that inventories of raw material & consumables and work-in-progress have been valued appropriately and as per generally accepted accounting policies and practices, the following procedures should be performed by CA Akshat:

**For Raw materials and consumables:**

- Ascertain what elements of cost are included e.g. carriage inward, non-refundable duties etc.
- If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analysed and accounted for/ treated in accounting records.
- Test check cost prices used with purchase invoices received in the month(s) prior to counting.
- Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.

**For Work in Progress:**

- Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
- Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- Ensure that material costs exclude any abnormal wastage factors.

**Question:** **The financial statements of XYZ Limited reflects long-term borrowings from the banks, financial institutions, leasing, and hire purchase companies. Additionally, the company has issued debentures to its 1000 members to raise funds in accordance with the provisions of the Companies Act, 2013. The money raised by issuing debentures is also reflected in long-term borrowings. As the statutory auditor of XYZ Limited, CA X wants to verify that all borrowings on the balance sheet represent valid claims by banks or other third parties. Suggest a few audit procedures in this regard.**

**(RTP SEP 2024)**

**Answer:** The audit procedures required to be undertaken by CA X while auditing borrowings is as follows:

- Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments are approved by the board of directors.
- Check the details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by the agreements are not exceeded.
- Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- Verify the details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a discharge is received on assets securing the debt.
- Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.

**Question:** **JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment during the year under audit. They have incurred an amount of Rs. 5,70,000/- on dismantling of an old plant, which had become obsolete, so that a new plant can be set up at the existing location. The Auditor**

**is in the process of verifying the cost incurred towards addition to Property, Plant and Equipment. What should be the accounting treatment of the amount spent on dismantling of old plant in the financial statements? Which elements of cost should be considered for valuing Property, Plant and Equipment.**

**(PYQ SEP 2024)**

**Answer:** In the given situation, JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment and incurred an amount of Rs.5,70,000 on dismantling of old plant which had become obsolete so that new plant can be set up at the existing location. An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost. The costs of dismantling, removing the item and restoring the site on which it is located referred to as decommissioning will form part of the new Property, Plant and Equipment.

Elements of Cost: The cost of an item of property, plant and equipment comprises:

i. its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
ii. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management
iii. the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

**Question:** **ABC & Co. are in the business of manufacturing toys. The stock taking process has been done by the company as on 31.3.2024. The company has used FIFO method for valuation of its inventories. The cost of inventory as on 31.3.24 is Rs.25,25,000/- and the net realizable value of the inventory on the same date is Rs.25,24,000/-.**

**The cost of inventory includes the following:**

**(1) Material purchase cost – Rs.25,05,000/-**

**(2) Allocated transport cost – Rs.18,000/-**

**(3) Abnormal wastage – Rs.2,000/-**

**The management seeks your advice in arriving at the value of inventory to be shown in the financial statements of the company. What should be the value of inventory in accordance with AS-2? (PYQ MAY 2024)**

**Answer:** Value of Inventory: Inventory to be recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Further, any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (e.g. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

In the given situation, ABC & Co. is using FIFO method for valuation of its inventories. Further, cost of inventory as on 31.03.2024 is rupees 25,25,000 which includes material purchase cost of rupees 25,05,000, allocated cost of transport of rupees 18,000 and abnormal wastage of rupees 2,000. Net realizable value of said inventory is Rs.25,24,000. In view of provisions of AS 2, cost allocated to transport for inventory is relating to bringing the inventory to the location, thus it will be added in cost of material. However, abnormal wastage of rupees 2000 should be excluded from cost of inventory.

Thus, cost of inventory will be Rs.25,25,000 – Rs.2,000 = 25,23,000 rupees and Net realizable value of inventory is Rs.25,24,000/-.

For valuation in accordance with AS 2, "Inventory", lower of cost and net realizable value will be considered. Accordingly, Rs. 25,23,000/- to be considered as value of inventory in the given situation.

**Question:** **Mr. Z, at the time of appointment as an independent director in EF Ltd. a listed company, came to know that the Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on internal controls for a listed Company. He wants to know the responsibilities as casted under Companies Act, 2013 with regards to Internal Financial Control for (1) Directors (2) Independent directors and (3) Audit committee as per section 134(5)(e), 149(8) & 177(4) (vii) respectively of the Companies Act, 2013.**

**(PYQ MAY 2024)**

**Answer:** Internal financial controls as per regulatory requirements: The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. The term "internal financial controls" is used at some places in Companies Act, 2013 casting responsibilities as under: -

| **Relevant provision of Companies Act,2013** | **Nature of Responsibility** |
|---|---|
| Section 134(5)(e) | In case of listed Companies, the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively. |
| As per Section 149(8) of the Act | The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible. |
| Section 177(4)(vii) of the Act | Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems. |

**Question:** LD Ltd. has given below loans to the following borrowers during the financial year 2023-24. Mr. B an auditor wants your guidance regarding additional regulatory information required to be provided under the Companies Act, 2013:

| Borrowers | Maximum Loan granted during the year 2023-2024 (Rs.in Lakh) | Outstanding Loan as at 31/03/2024 (Rs.in Lakh) |
|---|---|---|
| X (Promoter) | 20 | 15 |
| Y (Director) | 30 | 25 |
| Z (KMP) | 10 | 05 |
| A(Related Party) | 20 | 10 |
| Others | 80 | 65 |
| Total | 160 | 120 |

**Answer:** As additional regulatory requirements, following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013,) either severally or jointly with any other person, that are:

(a) repayable on demand or

(b) without specifying any terms or period of repayment.

| Type of Borrower | Amount of loan or advance in the nature of loan outstanding (Rs.In Lakhs) | Percentage to the total Loans and Advances in the nature of loans (Rs.in Lakhs) |
|---|---|---|
| X (Promoter) | 15 | 12.5% =15/120 X 100 |
| Y (Director) | 25 | 20.833% =25/120 X 100 |
| Z (KMP) | 05 | 4.167% =5/120 X 100 |
| A (Related Party) | 10 | 8.333% =10/120 X 100 |

**Question:** PQ & Co. want to diversify its business and for that purpose they want to raise money by issuing shares to the general public. The face value of the shares is Rs.100 but the directors of the company propose to issue the shares at a discounted rate of Rs.95/- so as to receive more response. The statutory auditor, however, objects to the same as it is not allowed as per the

**Companies Act, 2013. State the provisions of Section 53 of the Companies Act, 2013 with reference to shares issued at a discount and the consequences where the company fails to comply with the provisions of this section. (PYQ MAY 2024)**

**Answer:** Shares issued at a discount: According to Section 53 of the Companies Act, 2013,

(1) a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.

(2) any share issued by a company at a discounted price shall be void.

Notwithstanding anything contained in above sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

(3) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.

**Question: HR & Associates are the auditors of a large manufacturing company. The company has recently invested huge amount in Property, Plant and Equipment (PPE) for its new unit. They have added many incidental expenses to the cost of PPE. The junior audit team members are not sure about which costs should be excluded from the cost of PPE. Give examples of costs that should not form part of costs of PPE.**

**Answer:** Examples of costs that are not costs of an item of property, plant and equipment are:

i. costs of opening a new facility or business, such as, inauguration costs;
ii. costs of introducing a new product or service (including costs of advertising and promotional activities);

iii. costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

iv. administration and other general overhead costs.

**Question:** **JK Ltd. has opened a new manufacturing unit and for that they want plant & machinery. Since the capital outflow will be huge, they are considering of taking it on lease. They have approached several parties and have shortlisted one of them who is ready to give the plant on lease for 11 years, which is approximately the estimated economic life of the asset. As per the agreement, JK Ltd. will bear the insurance and maintenance expenses of the asset. Which kind of lease agreement have JK Ltd. Entered into and what is the ownership status, the accounting treatment and the tax benefits of the same?**

**(PYQ MAY 2024)**

**Answer:** In the given situation, JK Ltd. has opened a new manufacturing unit and for that they want plant & machinery. They have taken the plant on lease for 11 years, which is approximately the estimated economic life of the asset. As per the agreement, JK Ltd. will bear the insurance and maintenance expenses of the asset.

Same will be considered as Finance Lease as per AS-19 since the lease term is for a major part of the economic life of the asset even if title is not transferred.

Status of Ownership: Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred.

Accounting treatment: Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.

Tax benefit: Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

**Question:** **Kyte Private Limited acquired an immovable property of substantial value during the financial year 2023-24, which is recorded in the financial statements as an addition in the Schedule of PPE. The auditor also observed that this immovable property has been mortgaged to a bank for availing credit**

**facilities. How should the auditor verify the rights and obligations assertion for this property to ensure the entity's legal ownership and identify any charges against it? (JAN MTP 2025)**

**Answer:** To verify the rights and obligations assertion regarding Property, Plant, and Equipment (PPE), the auditor must ensure the entity has valid legal ownership and identify any charges against it. The audit procedures should include the following:

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify title deeds for immoveable property acquired.
- In case, the entity has given such immoveable property as security for any borrowings and the original title deeds are not likely to be available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.
- The auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

**Question: As the statutory auditor of Ginni Ltd., you need to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on March 31, 2024. What audit procedures should you perform to verify the company's ownership of the inventories, including items stored at third-party locations? (MTP JAN 2025)**

**Answer:** The statutory auditor of Ginni Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on March 31st, 2024.

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

- Evaluate the consigned goods.
- Examine client correspondence, sales and receivables records, purchase documents.
- Determine existence of collateral agreements.
- Review consignment agreements.
- Review material purchase commitment agreements.
- Examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- Obtain confirmation for significant items of inventory.
- For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

**Question: During the audit of a company, CA Atul noticed that company is facing significant skilled labour shortages resulting in hampering operations of the company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in leaving their native villages.**

**The company failed to keep its commitments due to such situation, consequently lost orders and faced decrease in its revenues. The fixed costs of the company remain at a high level. As a result, the company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of the company are also not willing to help the company to tide over liquidity crisis. The auditor has doubts over going concern status of the company. How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditors in such a situation? (MTP JAN 2025)**

**Answer:** Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.

The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast.

The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

**Question: During the audit of HST Ltd., CA Mukund, the auditor, observed a significant volume of unsold electronic parts as inventory that had remained stagnant for more than two years. He noted that the company was facing difficulty selling these items due to the changes in the market. Additionally, some parts were damaged, and others were discontinued models. CA Mukund also ensured that the inventory was accurately valued to ensure proper financial reporting. You are required to outline the detailed audit procedures that are generally undertaken when auditing such inventories which at the time of observance of physical counting were noted as being damaged or obsolete.**

**Answer:** Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory.

For the purpose, request the client to provide inventory ageing split and follow up for any inventories which at time of observance of physical counting were noted as being damaged or obsolete.

- Compare recorded costs with replacement costs.
- Examine vendor price lists to determine if recorded cost is less than current prices.
- Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, test overhead allocation rates and ensure that only direct labour, direct material and overhead have been included.
- Verify the correct application of lower-of- cost-or-net realizable value principles.

**Question: M/s AR & Associates have been appointed as statutory auditors of Future Limited, a company engaged in the business of manufacturing of hardware products. They are analyzing the monthly trends for other expenses like rent, power and fuel, repairs, etc. and are also verifying attributes of such types of expenses. List down the attributes for verifying such expenses.**

**(MTP JAN 2025)**

**Answer: Attributes for verifying other expenses like Power and Fuel, Repair etc.:** An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

(i) Whether the expenditure pertained to current period under audit;

(ii) Whether the expenditure qualified as a revenue and not capital expenditure;

(iii) Whether the expenditure had a valid supporting document like travel tickets, insurance policy, third party invoice etc.;

(iv) Whether the expenditure has been classified under the correct expense head;

(v) Whether the expenditure was authorised as per the delegation of authority matrix;

(vi) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

# Chapter-6: Audit Documentation

**Question 10: CA Ripun completed the audit of a listed company, and the audit report was issued on July 17th, 2024. However, he had not properly organized the audit working papers, including records of discussions with management, audit procedures performed, and conclusions reached. More than six months after issuing the report, he received a letter from the regulator in connection with audit of the company requesting him to share copy of audit file. In a hurry, CA Ripun quickly assembled the audit file, adding some papers he thought were necessary, but he used the current date on these newly added documents. He then sent the audit file to the regulator. Discuss the issues involved related to "audit documentation" and assembling of the final audit file in this case.** ***(RTP Jan 2025)***

**Answer 10:** The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- SQC 1, "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
- An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

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

**Question 11: An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Explain stating clearly the examples of significant matters. (RTP SEP 2024)**

**Answer 11:** As per SA 230, "Audit documentation" judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- Matters that give rise to significant risks.
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results.

Documentation of the professional judgements made, where significant, explains the auditor's conclusions and reinforces the quality of the judgement.

Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

**Question 12:** **M/s. PK & Company, Chartered Accountants, are the statutory auditors of JC Limited. CA Tarun, partner of M/s. PK & Company, was entrusted to supervise and verify the inventory items as on 31.03.2024. During the process of verification, a large chunk of draft inventory sheets were accumulated and then a final inventory sheet was prepared. The audit assistant has kept all these drafts and the final inventory sheet in the audit file. Is the approach of the audit assistant correct? Which papers/ documents may not be included in the audit documentation? (PYQ SEP 2024)**

**Answer 12:** In the given case, the audit assistant has kept a large chunk of draft inventory sheets and the final inventory sheet in the audit file which is not correct as the auditor is not required to document draft inventory sheets. Auditor should ensure that only final inventory sheets will form part of the audit documentation. Thus, approach of the audit assistant of filing draft and final inventory sheet is not correct.

As per SA 230, "Audit documentation", audit documentation may be recorded on paper or on electronic or other media.

The auditor need not include in audit documentation:

• superseded drafts of working papers and financial statements,

• notes that reflect incomplete or preliminary thinking,

• previous copies of documents corrected for typographical or other errors, and

• duplicates of documents.

**Question 13:** **CA B, an auditor, after the completion of busy audit season, was occupied in assembling of final audit files of one of his client. First of all, he started preparing various documents of that client and then kept those documents in various folders. He was preparing documents as well as audit file in paper form because he believed that it is mandatory. He could complete documentation as well as assembling of final audit file of that client after three months from the date of audit report. Generally, he retains audit file of the**

**clients for 4 years from the date of audit report. Check the validity of the action of CA B. (PYQ MAY 2024)**

**Answer 13:** Assembly of the Final Audit File:

Audit documentation may be recorded on paper or on electronic or other media. Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. Hence the views of CA B that audit documentation should be maintained mandatorily in paper form is not correct.

The auditor shall prepare audit documentation on timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. Completing the audit Documentation by CA B not on timely basis is not proper.

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. In the given situation, CA. B, after completion of audit season, is completing the audit file as well as assembling of final audit files of his client after three months of the date of audit report which is not valid as per SQC 1.

SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and Related Services", requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report. He retains audit file of the client for 4 years from the date of audit report is also non-compliance of SQC 1.

**Question 14:** **M/s KSJS & Associates are the statutory auditors of Moon Ltd. for the financial year 2023-24. During an audit briefing, CA Sanket, the engagement partner, explained that the auditor must assemble the audit documentation in an audit file and complete the administrative process of**

**finalising the audit file on a timely basis after the date of the auditor's report. He also highlighted the requirements of SQC 1 regarding establishment of policies and procedures for the retention of engagement documentation in a firm. Explain the requirements related to the timely assembly and retention of audit files in accordance with relevant Engagement and Quality Control Standards. (MTP JAN 2025)**

**Answer 14:** The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
- An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.**Examples of such changes include:**
    - Deleting or discarding superseded documentation.
    - Sorting, collating and cross-referencing working papers.
    - Signing off on completion checklists relating to the file assembly process.
    - Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.
- After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

**Question 15: CA Tanuj, the auditor of Kiran Ltd., completed the audit work and issued the auditor's report on 18th August 2024 for the financial year ended on 31st March 2024. During the final assembly of the audit file, he discarded some supporting schedules as same were outdated and corrected cross- referencing errors of working papers. No new audit conclusions were drawn, and the final audit file was assembled on 10th October 2024.**

**On the basis of Standards on Auditing regarding audit documentation, comment on the action taken by CA Tanuj. (MTP JAN 2025)**

**Answer 15:** As per SA 230, "Audit Documentation", the auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.
- After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

In the given situation, the auditor CA Tanuj has issued the auditor's report on 18th August 2024 for the financial year ended on 31st March 2024. However, he discarded some supporting schedules and corrected cross-referencing errors of working papers during the final assembly of the audit file by 10th October 2024 which is under prescribed time-limit of 60 days from the issuance of auditors report. Further, no new audit conclusions were drawn. Thus, CA Tanuj can make said changes to the audit documentation during the final assembly process.

# Chapter-7: Completion and Review

**Question: During the audit of a company, CA Kartik has noticed that company's turnover has fallen drastically as compared to last three years due to loss of its major markets and key customers. The company is in need of funds for new product development, but bankers are not willing to lend financial support. Which additional audit procedures need to be performed by CA Kartik in accordance with SA 570 when such events or conditions are identified?** ***(RTP Jan 2025)***

**Answer:** Loss of major markets, key customers and inability to obtain financing for new product development are examples of events or conditions that may cast a significant doubt on the entity's ability to continue as going concern.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

(a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions: -

   (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

   (ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

**Question: CA Manoj is the statutory auditor of a company. He has completed the audit and issued the audit report dated June 30, 2024. Before signing the audit report, written representations dated June 29, 2024, were obtained from the management of the company. Discuss the significance of the date of written representations. Also state whether the written representations obtained on June 29, 2024 is appropriate or not. (RTP SEP 2024)**

**Answer:** As per SA 580,"Written Representations" the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.

Since written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated before the date of the written representations. Furthermore, because the auditor must consider events occurring up to the date of the auditor's report that might require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In the given situation, CA Manoj obtained written representations dated June 29, 2024, from the management of the company before signing the audit report on June 30, 2024.

From the above is can be concluded that written representations have been obtained appropriately.

**Question: While conducting audit of BYN Limited, CA Y notices that company has lost one of its key markets along with important customers. Additionally, several highly successful competitors have emerged, impacting business of the**

**company. Despite the existence of material uncertainty, CA Y finds the use of going concern basis of accounting appropriate for preparation of financial statements. The company has also disclosed material uncertainty in notes to accounts adequately. How should he deal with the matter in auditor's report?** ***(RTP SEP 2024)***

**Answer:** As per SA 570, "Going concern", If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to: -

(a) Draw attention to the note in the financial statements that discloses such matters.

(b) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

**Question:** **CA Vasu was appointed as the statutory auditor of M/s. Pizza Limited for the financial year 2023-24. While reviewing the internal controls, he observed that the company has entered into many transactions with firms in which the directors are interested. The company's specified procedure was by-passed in such transactions. CA Vasu considered it as a significant deficiency in internal control over related party transactions. He communicated this deficiency to Those Charged With Governance (TCWG) as under, "Controls over significant transactions with related parties are weak." In view of the above, please explain**

i. **What is meant by deficiency in internal control?**

ii. **As per SA 265, whether the significant deficiency communicated by CA Vasu to TCWG is appropriate? Explain.**

**Answer:** (i) Meaning of Deficiency in internal control: This exists when

1. A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or
2. A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is

missing.

(ii) As per SA 265, While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of transactions with firm in which the directors are interested. It should explain that such a significant deficiency can lead to misstatement of transactions with related party. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

**Question: CA Z, the auditor of MNO Ltd., during the course of audit, assesses a risk of material misstatements regarding the litigations and claims involving the company. CA Z is not convinced with the management's explanations regarding the status of the litigations or claims. It is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general enquiry. The auditor sent a letter of specific enquiry requesting the entity's external legal counsel to communicate directly with the auditor. List out the inclusions in the letter of specific enquiry.**

**In certain circumstances the auditor may judge it necessary to meet with entity's external legal counsel to discuss the likely outcome of the litigations or claims. What will be auditor's reporting responsibility if the management refuses to give permission to the auditor to communicate or meet with the external legal counsel?**

**Answer:** A letter of specific inquiry includes:

i. A list of litigation and claims;

ii. Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

iii. A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. Further, if management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding, and the auditor is unable to obtain sufficient appropriate evidence by performing alternate audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

Alternatively, if the auditor is able to perform alternate audit procedures and can obtain sufficient and appropriate audit evidence to resolve the issue, then he can give an unmodified opinion.

**Question: ABC Pvt. Ltd., a manufacturing company, is facing significant financial difficulties due to downfall in market and increase in cost of production. CA Ram, the auditor of ABC Pvt. Ltd. has identified the following conditions:**

- **The company has defaulted on a major loan repayment.**
- **Current liabilities exceed current assets by 50%.**
- **Sales revenue has declined by 30% compared to the previous year.**

**Management has not yet performed an assessment of the company's ability to continue as a going concern, but they provided assurance for implementing corrective measures, including cost-cutting initiatives and discussions with creditors for restructuring the loan.**

**Which additional audit procedures need to be performed by CA Ram in accordance with SA 570 when such events or conditions are identified?**

**(MTP JAN 2025)**

**Answer:** SA 570, "Going Concern", deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

a. Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
b. Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
c. Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
    i. Evaluating the reliability of the underlying data generated to prepare the forecast; and
    ii. Determining whether there is adequate support for the assumptions underlying the forecast.
d. Considering whether any additional facts or information have become available since the date on which management made its assessment.
e. Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

# Chapter-8: Audit Report

**Question 17: The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements.**

**Explain clearly the differences between the approaches stating the essential audit reporting. Also define comparative information and audit procedures regarding comparative information.** *(RTP JAN 2025)*

**Answer 17:** The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in terms of engagement.

**The essential audit reporting differences between the approaches are**

a. For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
b. For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented

**Definition of Comparative Information** – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework

**Audit Procedures regarding comparative information**

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed

**Question 18: Kiran, a CA student, was reviewing an audit report of the company when she noticed an 18-digit alphanumeric code below the auditor's signature and membership number. She wants to understand the purpose and importance of this randomly generated number as unique code. Is this code required for audit reports only? *(RTP JAN 2025)***

**Answer 18:** The 18-digit alpha numeric number noticed by her at the end of the audit report is Unique Document Identification number (UDIN). It is a system generated unique number. It was noticed that financial documents/ certificates attested by third persons misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders. ICAI also received number of complaints of signatures of CAs being forged by non CAs. To curb the malpractices, ICAI implemented the concept of UDIN i.e. Unique Document Identification Number. Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them. An auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report and Certificates.

It is required to be stated in case of audit reports and certificates.

**Question 19: Discuss the reporting requirements as per CARO, 2020, regarding:**

(i) **Statutory Dues**

(ii) **Transactions with Related Parties** (RTP SEP 2024)

**Answer 19:**

**(i) Reporting under CARO,2020 regarding statutory Dues [Para 3(vii)]**

(a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute)

**(ii) Reporting under CARO,2020 regarding transactions with related parties [Para 3(xiii)]**

Whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards.

**Question 20: M/s. PQ Limited has a turnover of ` 807 crores during the financial year 2023-24. It has outstanding dues towards Goods and Services Tax (GST) of Rs.10 lakhs since June 2023. When enquired by the auditor, the company's management informed him that they have filed an objection letter for the said demand with the GST Authorities, however, no response is received from the GST Department. State the reporting responsibility of the auditor under paragraph 3, clause (vii) of the Companies Auditor's Report Order, 2020 [CARO, 2020]. (PYQ SEP 2024)**

**Answer 20:** Reporting responsibility of the auditor under paragraph 3 of CARO, 2020: The auditor is required to report as per clause (vii) (a) of Paragraph 3 of CARO, 2020 that whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

Further, the auditor is also required to report as per Clause (vii) (b) of Paragraph 3 of CARO, 2020, where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute).

**Question 21: CA Ayush has recently qualified and has joined a CA Firm. On going through various audit reports, he observed that different phrases were used to express an unmodified opinion on the financial statements. On enquiring with a senior, he got to know that all those phrases can be regarded as being equivalent. Which phrases are appropriate and which phrases are inappropriate while drafting an unmodified opinion? (PYQ SEP 2024)**

**Answer 21:** Appropriate and Inappropriate Phrases while drafting an Unmodified Opinion: When expressing an unmodified opinion on financial statements, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

(i) In our opinion, the accompanying financial statements present fairly, in all material respects, […] in accordance with [the applicable financial reporting framework]; or

(ii) In our opinion, the accompanying financial statements give a true and fair view of […] in accordance with [the applicable financial reporting framework].

The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent.

Inappropriate Phrases: When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

**Question 22: "When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." Briefly explain when the auditor should express:**

(i) **Qualified Opinion.**

(ii) **Adverse Opinion and**

(iii) **Disclaimer of Opinion.** **(MTP JAN 2025)**

**Answer 22:** "When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." The auditor should consider the following while expressing the opinion in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

(i) **Qualified Opinion**

- The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, are material, but not pervasive or
- The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) **Adverse Opinion:** The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

(iii) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and he concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

**Question 23: During the audit of a limited company as a statutory auditor you discovered that a fraud amounting to Rs. 5 lakh has been committed by the**

**company. What are the reporting requirements regarding fraud under the Companies Auditor's Report Order, 2020? (MTP JAN 2025)**

**Answer 23: Reporting requirements of a fraud under the CARO 2020:** The auditor is required to report the fraud under clause (xi) of Paragraph 3 of CARO 2020:

(a) whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

(b) whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

(c) whether the auditor has considered whistle-blower complaints, if any, received during the year by the company

**Question 24: CARO, 2020 shall apply to every company including foreign company. However, it specifically exempts certain class of companies. State which class of companies are specifically exempt from the applicability of CARO, 2020?**

**(MTP JAN 2025)**

**Answer 24:** CARO, 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except:

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(ii) an insurance company as defined under the Insurance Act,1938 (4 of 1938);

(iii) a company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and

(v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

**Question 25: ASD Limited's business has grown from one state of India to various countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible? (MTP JAN 2025)**

**Answer 25: Joint Audit of Financial Statements:** As per SA 299, "Joint Audit of Financial Statements", all the joint auditors shall be jointly and severally responsible for:

(i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

(ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;

(iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;

(iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;

(v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;

(vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

# Chapter-9: Special Features of Audit of Different Type of Entities

**Question 43:** **An NGO based in Kolkata collected significant donations for flood victims in Bihar. The funds were distributed to various NGOs operating in Bihar to support relief efforts. You have been appointed as the auditor for this NGO's accounts for the year in which it collected and disbursed these donations. Draft an audit program to audit the receipts of donations and the remittance of the collected funds to different NGOs.** [RTP JAN 2025]

**Answer 43:** **Receipt of Donations:**

(i) Internal Control System: Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.

(ii) Custody of Receipt Books: Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.

(iii) Receipt of Cheques: Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.

(iv) Bank Reconciliation: Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

(v) Cash Receipts: Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.

(vi) Foreign Contributions, if any, to receive special attention to compliance with applicable laws and regulations.

## Remittance of Donations to Different NGOs:

(i) Mode of Sending Remittance: All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.

(ii) Confirming Receipt of Remittance: All remittances are supported by receipts and acknowledgements.

(iii) Identity: Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.

(iv) Direct Confirmation Procedure: Send confirmation letters to entities to whom donations have been paid.

**Question 44: Section 77 of Multi-State Cooperative Societies Act, 2002 states that the Central Government may at any time by order direct that a special audit of the Multi-State Co-Operative Society's accounts for such period or periods as may be specified in the order, shall be conducted. Further, it may by the same or a different order appoint either a Chartered Accountant or the Multi-State Co-Operative Society's auditor himself to conduct special audit. Under which circumstances such power can be exercised by the Central Government? (RTP SEP 2024)**

**Answer 44:** The Central government has power to order special audit of Multi-State Cooperative Society's Accounts where it is of the opinion -

(a) that the affairs of any multi-state co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles or

(b) that any multi-state co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains or ;

(c) that the financial position of any multi-state co-operative society is such as to endanger its solvency.

**Question 45: P Financial Services Ltd. (PFSL) is a leasing & hire purchase company. You, as an auditor of PFSL, are in the process of examining finance lease agreements executed by them for equipment given on lease. Which points shall be noted by you while examining a particular finance lease agreement entered into by PFSL in respect of a leasing transaction? (PYQ MAY 2024)**

**Answer 45:** The lease agreement should be examined, and the following points may be noted:

(i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).

(ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

(iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.

(iv) whether the agreement prohibits the lessee from subletting the equipment and authorises the lessor to do so.

**Question 46: Sanskar Foundation is a Non-Governmental Organisation (NGO) for orphan children. They have received voluntary contribution of Rs. 50 lacs from the promoters, specifying that Rs. 20 lacs are towards the Corpus contribution and ` 30 lacs are towards Revolving fund. Explain the terms "Corpus contribution" and "Revolving fund".(PYQ MAY 2024)**

**Answer 46:** A contribution made towards the capital or the corpus of an NGO is known as corpus contribution. The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO. Such contributions are generally given with reference to the total funds required by an NGO.

The objective of a contribution or grant towards a Revolving Fund is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and

Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.

**Question 47: You are appointed as an auditor of "The Prestigious Township Club". As the auditor of "The Prestigious Township Club" for the financial year 2023-24, what are the key points you would consider while auditing the income and expenditure items of the club? (MTP JAN 2025)**

**Answer 47:** The following points need to be considered while auditing income and expenditure items of a club: -

(1) Entrance Fee: Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.

(2) Subscriptions: Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

(3) Arrears of Subscriptions: Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.

(4) Arithmetical accuracy: - Check totals of various columns of the Register of members and tally them across.

(5) Irrecoverable Member Dues :- See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.

(6) Pricing: Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

(7) Member Accounts: Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.

(8) Purchases: Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.

(9) Margins earned: Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.

(10) Management Powers: Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

**Question 48: Aman Cooperative Society appointed FAB & Associates as an auditor for the financial year 2023-2024. During the audit, the auditors noted the following details :**

| | |
|---|---|
| Number of shares | 1000 shares @ Rs.10/- each |
| Net Profit before compulsory transfer to reserve fund | Rs.10,000/- |
| Net Profit after compulsory transfer to reserve fund | Rs.8000/- |

(I) **Mr. Dhairya, a member of society, holds 200 shares amounting to**
**₹ 2000 from the previous year.**

(II) **Upon verifying the society's borrowings, the auditors found that Cooperative Society had accepted a loan from Mr. Shivam, a non- member. The auditors did not find any restrictions regarding this in the society's bye laws.**

**Comment on the above transactions of the society with reference to the Co-operative Societies Act, 1912. (MTP JAN 2025)**

**Answer 48: Restrictions on share holdings:** - According to section 5 of the Central Act, in the case of a society where the liability of a member of the society is limited, no member of a society other than a registered society can hold such portion of the share capital of the society as would exceed a maximum of twenty percent of the total number of shares or of the value of shareholding to ₹ 1,000/-.

**Restrictions on borrowings** - Section 30 of the Central Act further puts restriction

CA INTERMEDIATE

on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect."

In the given situation, Mr. Dhairya, a member of the society, is holding 200 shares amounting to ₹ 2000 from the previous year. In view of the aforementioned restriction on shareholding by a member, Mr. Dhairya is allowed to hold a maximum of 100 shares according to the Act.

Further, Aman Co-operative Society had accepted a loan from Mr. Shivam, a non-member. Since, there are no restrictions regarding the acceptance of loan received from non-member in the society's bye-laws, the loan received from Mr. Shivam is permissible.

# Chapter-10: Audit of Banks

**Question 27: Agrim, a CA student, is part of an engagement team conducting audit of Madurai branch of ARB Bank. CA Bhuvan, engagement partner, has asked him to verify provision made by branch as on March 31st, 2024 in respect of the following non-performing assets: -**

| Name of Account | NPA classification | Outstanding amount as on March 31st, 2024 (In Rs. lakhs) | Amount of provision made (In Rs. lakhs) |
|---|---|---|---|
| AK Industries | Doubtful (D1) | 10.00 | 5.00 |
| Jupiter Traders | Substandard asset | 50.00 | 7.50 |
| VT & Co. | Doubtful (D2) | 30.00 | 30.00 |
| ASD & Sons | Loss | 1.00 | 1.00 |

**The engagement partner has already verified NPA classification. Outstanding amounts as on March 31st, 2024, relating to each NPA account listed above (except ASD & Sons) are fully secured. However, only personal guarantee of proprietor (Net worth of proprietor `50 lakhs) is available in account of ASD & Sons. Comment on the correctness of the above provisions.**

**Agrim is in dilemma regarding classification of above accounts as NPA although these are fully secured or guaranteed. Guide him. [RTP JAN 2025]**

**Answer 27:** The auditor is required to ensure that provision for NPA is made as per its classification in different categories which are given as under:

| Categories of Non-Performing Assets: | Provision required |
|---|---|
| □ **Substandard Assets:** | |
| Would be one, which has remained NPA for a period less 12 months. | 15% |
| □ **Doubtful Assets:** Would be one which has remained in the substandard category for a | |

| | |
|---|---|
| of 12 months.<br>**<u>Sub-categories</u>**:<br>Doubtful up to 1 Year (D1)<br>Doubtful 1 to 3 Years (D2)<br>Doubtful more than 3 Years | (Secured + Unsecured) 25% + 100%<br>40% + 100%<br>100% + 100% |

From the above provision, it can be concluded that in case of:

**AK Industries**- It has been classified as Doubtful (D1) category. Therefore, it requires provision of 25% of secured amount. That is provision of Rs 2.50 lakh (i.e 25% of Rs.10 lakh) should be made instead of Rs.5 lakh.

**Jupiter Traders**- It has been classified as Substandard asset. It requires provision of 15% of outstanding amount (i.e 15% of Rs.50 lakhs) which comes to Rs.7.50 lakh. Therefore, provision made by the branch is correct.

**VT & Co.-** It has been classified as Doubtful (D2) category. It requires provision of 40% of secured amount. That is provision of Rs.12.00 lakh (40% of Rs. 30 lakhs) should be made instead of Rs.30 lakh.

**ASD & Sons-** It has been classified as a loss asset which requires provision of 100% of outstanding amount. Therefore, the provision made by the branch is correct.

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Hence, these accounts have been classified as NPA on the record of recovery although these are fully secured or guaranteed.

**Question 28: Compute the Drawing Power for Cash Credit A/c of Kirpa Limited for the month of March 2024 with following information:**

| | *(Amount in Rs.)* |
|---|---|
| **Stock** | **60,000** |
| **Debtors** | **55,000** |
| **(Including Debtor of Rs.15,000 for an invoice dated 20.10.2023)** | |

**Sundry creditors** **10,000**

**Sanctioned Limit** **48,000**

**Margin on stock is 30% and on debtors is 40%.**

***Note: Debtors older than 3 months are ineligible for calculation of DP.***

***(RTP SEP 2024)***

**Answer 28:** Computation of Drawing Power (DP) for CC A/c of Kirpa Ltd.

| **Particulars of current assets** | | **Amount (Rs.)** | **DP Amount (Rs.)** |
|---|---|---|---|
| (A) Stocks: | | | |
| Stocks at realizable value | | 60,000 | |
| *Less:* Unpaid stocks: | | | |
| - Sundry creditors | 10,000 | 10,000 | |
| Paid for stocks | | 50,000 | |
| Margin @ 30% | | 15,000 | 35,000 |
| (B) Debtors: | | | |
| Total Debtors | | 55,000 | |
| *Less:* Ineligible debtors | | 15,000 | |
| Eligible debtors | | 40000 | |
| Margin @ 40% | | 16,000 | 24,000 |
| Total Drawing Power | | | 59,000 |

The sanctioned limit given in the question is Rs. 48,000/- whereas drawing power as per the above working is Rs.59,000/-. So, drawing power would be restricted to sanctioned limit i.e., Rs.48,000/-.

**Question 29: Schedule III of the Companies Act, 2013 prescribes disclosure of certain ratios as a part of Additional Regulatory Information. Mention any 3 ratios that should be disclosed along with the Rules relating to disclosure of these ratios. (PYQ SEP 2024)**

**Answer 29:** Disclosure of Ratios as a part of Additional Regulatory Information as per Schedule III of the Companies Act 2013 and its Rules relating to disclosure are:

(1) Current Ratio,

(2) Debt-Equity Ratio,

(3) Debt Service Coverage Ratio,

(4) Return on Equity Ratio,

(5) Inventory turnover ratio,

(6) Trade Receivables turnover ratio,

(7) Trade payables turnover ratio,

(8) Net capital turnover ratio,

(9) Net profit ratio,

(10) Return on Capital employed,

(11) Return on investment.

Rules relating to disclosures of Ratios: The company shall explain the items included in the numerator and denominator for computing the above ratios.

Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

**Question 30: K Ltd. is availing cash credit limit of Rs.25 crores from LMN Bank Ltd. The drawing power of the company range between Rs.22 crores and Rs.25 crores during the year 2023-24. The limit availed by the company remained less than Rs.20 crores during all the days of the financial year 2023-24. The company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters. How will this account be classified in the books of LMN Bank Ltd. as on 31-03-2024? Explain.**

**Answer 30:** An account should be treated as 'out of order' if: -

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

In the given case, K Ltd. is availing cash credit limit of Rs. 25 crores from LMN Bank Ltd and the drawing power of the company range between Rs. 22 crores and Rs. 25

crores during the year 2023-24. The limit availed by K Ltd. remained less than Rs.20 crores during all the days of the financial year 2023- 24 and the company has not deposited any amount in the cash credit account and there are no other credits to this account during the last two quarters.

Thus, account should be treated as out of order in the books of LMN Bank Ltd. as the outstanding balance in the principal operating account (Rs.20 crore) is less than the sanctioned limit/drawing power (Rs.22 cores and Rs.25 crores), but there are no credits continuously for 90 days as on the date of Balance Sheet.

**Question 31: You are the auditor of Plus Bank Limited. The bank has made following provisions for the year ended on 31.03.2024:**

| Particulars | Amount (Rs.in crores) |
|---|---|
| Provision for Bad Debts | 66 |
| Provision for Sub-standard Assets | 78 |
| Provision for Expenses | 24 |
| Provision for Income Tax | 55 |

**You are in the process of verifying the provisions and contingencies of the bank. What audit approach and procedures will you adopt to verify the above?**

**(PYQ SEP 2024)**

**Answer 31:** For audit of provisions and contingencies the auditor should:

- ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.

- examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

**Question 32: MNB bank advanced certain loans guaranteed by government. State the prudential norms for asset classification and income recognition of such loans.**

**Answer 32:** Government Guaranteed Advances (In case of accounts overdue for more than 90 days): Central Government. Guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.

The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

Alternative Solution:

Government Guaranteed Advances (In case of accounts overdue for not more than 90 days):

Asset Classification: In case of advances guaranteed by both Central Government and State Government, they would be classified as Standard Advances in the following manner:

| Classification of Advances | Particulars |
|---|---|
| Standard Regular | Accounts not overdue |
| Special Mention Accounts: | |
| 1. SMA 0 | Accounts showing stress signals |
| 2. SMA 1 | Accounts overdue between 31 to 60 days |
| 3. SMA 2 | Accounts overdue between 61 to 90 days |

Income Recognition

Income would be recognised for all the accounts which are not overdue for more than 90 days, on accrual basis, in case of advances guaranteed by both Central Government and State Government.

**Question 33: Mahavir and Associates is appointed as the statutory auditor of KBC Bank for the financial year 2023-2024. During the audit, Ms. Chandana, an article trainee, noticed that Sidharth Industries had an outstanding loan of Rs.50,00,000 as on March 31, 2024. On March 29, 2024, the company made a payment of Rs.10,00,000, reducing the outstanding loan balance to Rs.40,00,000. However, on April 4, 2024, Sidharth Industries initiated a reversal transaction of Rs.8,00,000, increasing the outstanding loan balance back to Rs. 48,00,000. The payment and subsequent reversal occurred within a short period, with the final outstanding balance remaining Rs.48,00,000 after the reversal.**

**Considering this scenario, what should be the response of Mahavir and Associates to this matter, particularly regarding the classification of the borrower's account and the potential risk of it slipping into the NPA category?**

**(MTP JAN 2025)**

**Answer 33: Accounts regularized near the Balance Sheet Date:** The asset classification of borrower accounts where a solitary or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. Where the account indicates inherent weakness on the basis of the data available, the account should be deemed as NPA.

The auditor should check for sample transactions immediately before the closing of the financial year and immediately after the closing of the financial year to get a knowledge of the objective behind the transactions if they have any relation to each other in the borrower accounts or if any/some transactions are being reversed during the first few days after closing which might show an arrangement to prevent the Borrower account(s) from slipping into the NPA category.

In the given case of Sidharth Industries, a payment of ₹10,00,000 was made on March 29, 2024 reducing the outstanding loan balance to Rs. 40,00,000. and subsequently reversed by ₹8,00,000 on April 4, 2024. Thus, Mahavir and Associates should carefully assess the classification of Sidharth Industries' Account, and determine if the payment and reversal transactions indicate an attempt to prevent the account from slipping into the NPA category. If yes, the account should be classified as an NPA in compliance with regulatory guidelines.

**Question 34: During the audit of Smile Bank, CA Sweety focused on understanding the risk management process of the bank. She reviewed how**

**management developed controls and used performance indicators to monitor key business and financial risks. CA Sweety also assessed whether the risk management system effectively identified and mitigated risks in required areas. How should CA Sweety evaluate the adequacy of the bank's risk management controls? (MTP JAN 2025)**

**Answer 34:** Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

(i) Oversight and involvement in the control process by those charged with governance: Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.

(ii) Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.

(iii) Control activities: A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.

(iv) Monitoring activities: Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.

Reliable information systems: Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

# Chapter-11: Ethics and Terms of Audit Engagements

**Question 16: CA Sudhakar has been appointed as the auditor of AMRO Ltd. Before accepting the appointment, he learns that his cousin, who held shares in the company and recently passed away without children, named him as the nominee for these shares, which have substantial value. Although holding such shares through a distant relative does not violate legal provisions or affect his independence, this unexpected inheritance places him in a dilemma. Advise CA Sudhakar on how he should deal with this situation and safeguard his independence.** *(RTP JAN 2025)*

**Answer 16:** In the given situation, holding shares by CA Sudhakar involves financial interest in the company and is in nature of self-interest threat. Though he has come to hold shares due to nomination made by his distant relative before accepting the appointment.

Chartered Accountants have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.

Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to comply with the fundamental principles to an acceptable level.

**To address the issue, the following guiding principles are to be applied: -**

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appear to be independent of the entities that they are auditing.
- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguard measures need to be recorded in a form that can serve as evidence of compliance with due process.
- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Considering above, holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence. Therefore, CA Sudhakar should take steps to eliminate the threat by selling shares immediately before accepting the appointment and in the absence of same, he should not accept the appointment as an auditor.

**Question 17: ABC & Associates, an audit firm, has been approached by a prospective company client that has been in business for about 10 years to conduct an audit of its financial statements. Before accepting the audit engagement, the firm wants to access the integrity of prospective client. With regard to the assessment of integrity, which matters should be considered by the audit firm? *(RTP SEP 2024)***

**Answer 17:** With regard to the integrity of a client, matters that ABC & Associates should considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.

**Question 18: PD & Co., Chartered Accountants, were appointed as the statutory auditors of MR Limited for the financial year 2023-24. MR Limited included the following clause in the appointment letter to the auditors: "The Auditor shall be responsible for detecting the frauds that may happen in the company during the financial year 2023-24."**

**The auditor objected to inclusion of such a clause in the appointment letter. Discuss in the light of scope of audit.**

**Answer 18:** Scope of Audit in detection of Fraud: In conducting audit of financial statements objectives of auditor, in accordance with SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

An audit is not an official investigation into alleged wrongdoing. The auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.

Audit is distinct from investigation. Investigation is a critical examination 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.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

Thus, inclusion of such a clause in the engagement letter is uncalled for and outside the scope of audit.

**Question 19: CA P is a professional accountant in service. In terms of employment and professional relationships with employer he has to be alert to the possibility of inadvertent disclosure of any information outside the employing organization. However, in view of disclosure required by law, CAP had to divulge the information and documents as evidence in course of legal proceedings. Whether CA P has violated any fundamental principle governing professional ethics in this case? Explain. (PYQ SEP 2024)**

**Answer 19:** Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.

However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorised by the client or employer or there is a professional duty or right to disclose when not prohibited by law.

In the given situation, CA P, who is a professional accountant in service, and in terms of employment and professional relationships with the employer he is alert to the possibility of inadvertent disclosures of any information outside the employing organization. However, CA P had to divulge the information and documents as evidence in the course of legal proceedings and same was required by law. Therefore, CA. P will not be held responsible for violation of fundamental principle of "Confidentiality" governing professional ethics.

**Question 20: A professional accountant is expected to comply with the fundamental principles of professional ethics at all times. Explain which fundamental principle governing professional ethics is violated in the following situations?**

1. A chartered accountant in practice accepted the appointment as an auditor of a firm in which his sister was a partner.
2. A chartered accountant in practice was approached by his friend to seek some insider information about a company, which was a client of the chartered accountant. He could not refuse his friend's request.
3. A chartered accountant in practice failed to inform his client about the change in laws applicable to his client.

**Answer 20: Fundamental Principles:**

1. Objectivity: The principle of objectivity requires that a professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity. Objectivity principle will be violated in the given situation where a chartered accountant in practice accepted the appointment as an auditor of a firm in which his sister was a partner.
2. Confidentiality: Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality principle will be violated in the given situation where a chartered accountant in practice could not refuse his friends requested to seek some insider information about a client company of the chartered accountant.
3. Professional Competence and Due care: A professional accountant shall comply

with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards. Professional Competence and Due Care principle will be violated in the situation where a chartered accountant in practice failed to inform his client about the change in laws applicable to his client.

**Question 21: CA M is the engagement partner of the firm M/s Y2Z LLP and he is auditing the financial statements of a listed entity ABC Ltd. The audit firm has determined that an engagement quality control review is required for this assignment. Discuss the responsibilities of CA M as an engagement partner for engagement quality control review as per SA-220. (PYQ MAY 2024)**

**Answer 21:** Engagement Performance: As per SA 220, for audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

(i) Determine that an engagement quality control reviewer has been appointed.

(ii) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

(iii) Not date the auditor's report until the completion of the engagement quality control review.

(iv) If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

**Question 22: CA Paras has accepted audit of financial statements of an entity. According to the Standards on Auditing, the auditor is required to send an audit engagement letter to the entity. What are the key areas that should be included in the audit engagement letter? Under what circumstances is the auditor not required to record the terms of engagement in such a written agreement? (MTP JAN 2025)**

**Answer 22:** Key areas that should be included in Audit engagement letter are:

(i) The objective and scope of the audit of the financial statements;

(ii) The responsibilities of the auditor;

(iii) The responsibilities of management;

(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements and

(v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

**Q-23: Deepa Ltd., initially requested an audit engagement for the financial year 2023-2024. However, midway through the audit process, the management claims that they are unable to provide complete supporting documentation for a significant portion of their receivables. As a result, the management asks the auditor to change the audit engagement to a review engagement, arguing that it would prevent the issuance of a qualified opinion.**

**The auditor is now facing challenge in determining whether this change is justified or not. Comment in accordance with relevant SA. (JAN 2025)**

**Ans-23:** As per SA 210, "Agreeing the Terms of Audit Engagements", a request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.

The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Hence Deepa Ltd.'s request for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion is not reasonable.

**Q-24: Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. Explain. (MTP JAN 2025)**

**Ans-24: Familiarity threats:** Familiarity threats are self-evident and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways including:

(i) close relative of the audit team working in a senior position in the client company;

(ii) former partner of the audit firm being a director or senior employee of the client;

(iii) long association between specific auditors and their specific client counterparts; and

(iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.

Provisions in Companies Act, 2013 regarding rotation of auditors mainly address these very familiarity threats. Such provisions prescribe that auditor is rotated after a certain number of years so that auditors do not become too familiar with their clients.