

CHAPTER 1 Nature & Scope of Audit

- Q1** **Q2** c. The management of Cool Drinks Limited suspects that some employees of the company may be involved in making fraudulent payments to dummy workers at its various plants in the country. Therefore, they are considering appointment of a firm of auditors to conduct audit involving detailed examination of accounts. However, one senior person among Board members, Mr. P, objects to use of word “audit” in proposed assignment. Comment. Also, discuss how audit is different from investigation. (4 Marks) (MTP -Series-I July24)

Ans:

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 objective of audit, on the other hand, 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.

The scope of audit is general and broad whereas scope of investigation is specific and narrow. In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of “investigation”.

Therefore, Mr. P is right in objecting the use of word “audit” in the proposed assignment.



STUDENT NOTES

Investigation → Scope of Audit

- Q2** 1(c) 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. (3 Marks) (Sept 24 - Exam Questions)

Ans:

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.



STUDENT NOTES

Scope of Audit

Q3

20. 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]

Jan25

Ans:

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.



STUDENT NOTES

Independence is safeguard

Q4

Mini & Associates, Chartered Accountants, were appointed as the auditor of CIN Ltd., a construction company. During the audit, CA Mini, a Partner of the firm noticed the following:

- The company has several ongoing projects, but only selected project revenues have been reported.
- Several expense vouchers are either missing or are handwritten and lack proper authorisation.
- The company has changed its depreciation method from the straight-line method to the written-down value method without adequate disclosure in the financial statements.

These matters were brought to the attention of management. However, management argued that these issues fall outside the auditor's scope of responsibility. Whether contention of the management is correct?

(RTP SEP25)

Ans:

The following points are included in scope of audit of financial statements:

(1) Coverage of all aspects of entity

Audit of financial statements should be organised adequately to cover all aspects of the entity relevant to the financial statements being audited.

(2) Reliability and sufficiency of financial information

The auditor should be reasonably satisfied that information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of financial statements.

The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

The auditor should also decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.

In view of above, the management's contention is not correct. The matters identified by CA Mini such as incomplete revenue recognition, missing or unauthorised expense vouchers, and inadequate disclosure of changes in accounting policy are well within the scope of the audit of financial statements, as they impact the reliability, completeness, and proper presentation of financial information.



STUDENT NOTES

scope of Audit

Q5

5(c) 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. (4 Marks) (MTP Series-2 JAN25)

Ans:

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.



STUDENT NOTES

Independence • Threat to Ind.

Q6

2(b) CA H is managing partner of HK & Co., a Chartered Accountant firm, having registered office at Delhi. With the annual task of reviewing whether any threat to independence is observed in the firm, CA H noted down the following observations received from the staff and partners of the firm for the F.Y. 2023-24 :

- (i) CA J, partner of the firm, performed statutory audit as well as non - audit engagement for M/s. Take Away Private Limited.
- (ii) CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.
- (iii) The costs of air travel and stay accommodation of family members of audit team for audit of Chennai was borne by the client stationed at Chennai.
- (iv) One of the clients, M/s. Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.

- (v) CA N, partner of the firm, who audited M/s. NM Private Limited became arbitrator for dispute between M/s. NM Private Limited and one of its vendors.
- (vi) CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.

You are requested to help CA H in classifying the type of threats to independence in each of the above observation received from the staff and partners of the firm. (3 Marks)

In case such threats exist, what should the auditor do? (2 Marks) (Exam Jan25)

Ans: Type of Threats to Independence

S.No.	Situation	Threat to Independence
(i)	CA J, partner of the firm, performed statutory audit as well as non- audit engagement for Take Away Private Limited.	Self-review threats
(ii)	CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.	Self-interest threats
(iii)	The costs of air travel and stay accommodation of family members. of audit team for audit Chennai was borne by the client stationed at Chennai.	Familiarity threats
(iv)	One of the clients, Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.	Intimidation threats
(v)	CA N, partner of the firm, who audited NM Private Limited became arbitrator for dispute between. NM Private Limited and one of its vendors.	Advocacy threats
(vi)	CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.	Self-interest threats

When such threats exist, the auditor should –

- (1) 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 safeguards' measures need to be recorded in a form that can serve as evidence of compliance with due process.
- (2) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.



STUDENT NOTES

Independence & Threats to Indep.

Q7 2(c) 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. (4 Marks)

(MTP Series-2 JAN25)

Ans: 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.



STUDENT NOTES

Advantage of Audit

Q8 5(c) 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. (3 Marks) (May 24 - Exam Questions)

Ans:

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.



STUDENT NOTES

Fundamental Principles + Ethical Req.

Q9

6(b) 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.

(4 Marks) (Sept 24 - Exam Questions)

Ans: 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.



STUDENT NOTES

confidentiality

Q10

6(c) Identify and explain the fundamental principles being referred to in the following cases.

- (i) Professional accountants should act diligently and in accordance with applicable technical and professional standards while providing professional services. (2 Marks)
- (ii) A professional accountant shall not knowingly be associated with reports where he believes that the information contains a materially false or misleading statement. (2 Marks)

(Exam Jan25)

Ans: Fundamental Principles:

- (i) Act diligently and in accordance with applicable technical and professional standards: In the given case, professional competence and due care fundamental principle is being referred to since 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.
- (ii) A professional accountant shall not knowingly be associated with reports where he believes that the information contains a materially false or misleading statement: In the given case, integrity fundamental principle is being referred to, it prescribes that a professional accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships. Integrity implies fair dealing and truthfulness.



STUDENT NOTES

fundamental Principles & Ethical Req.

Q11

(c) As the auditor of CRT Ltd., a construction company, for the year 2023-24, you are preparing an audit programme to systematically guide the audit procedures. A well-structured audit programme not only ensures efficient execution but also serves as documentary evidence in case of any allegations of negligence against the auditor. In this context, briefly explain advantages of audit programme that will supports the auditor during the audit of CRT Ltd. (4 Marks)

(MTP S1 March 25)

Ans: The advantages of an audit programme are:

- (i) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.

- (ii) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- (iii) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- (iv) 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 danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less, and the audit can proceed systematically.
- (v) 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.
- (vi) 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.
- (vii) It serves as a guide for audits to be carried out in the succeeding year.
- (viii) 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.



STUDENT NOTES

Ch.2 → Advantage of Audit Progr.

Q12

9. XYZ Ltd., a manufacturing company based in India, operates multiple plants across the country and deals in complex machinery, which requires specialized maintenance and valuation expertise. XYZ Ltd. appointed CA Dhruv as Statutory auditor. During the audit, he observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher reported profits. Does such a matter fall within scope of audit?

(RTP MAY25)

Ans: The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The scope of audit of financial statements includes coverage of all aspects of entity, reliability and sufficiency of financial information and proper disclosure of financial information.

In the given situation, CA. Dhruv observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher profits. Since proper disclosure of financial information is covered under the scope of audit, thus, the auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Thus, it can be concluded that proper disclosure of financial information is well within scope of audit.



STUDENT NOTES

scope of Audit

Q13

10. 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 Sep24)

Ans:

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.



STUDENT NOTES

Independence & Safeguards

Q1

1c. Truthful Products Private Limited is engaged in trading stationery items.

During the year 2023-24, there was a huge fire in one storage location of the company resulting in loss of inventories of ₹ 5 crores. As a result, the operations of the company

were badly affected for about two months. Unfortunately, the insurance claim of the company was rejected due to certain defects in the policy issued and loss was booked by company in the year 2023-24 itself. There was no change in nature of business of company in relation to the last year. The draft financial statements of the company reflect following information:

Figures in ₹ crores)

Particulars	FY 2022-23	FY 2023-24
Revenue from Operations	80	100
Net profit before tax	6	10

CA D who has been the statutory auditor for past three years, has decided to rely upon the same tests of details as performed in previous years. In the given situation what is lacking on part of the auditor? Discuss. (4 Marks) (MTP Series-II AUG24)

Ans:

Maintaining professional skepticism throughout audit is necessary if auditor is to reduce risks of overlooking unusual circumstances and using inappropriate assumptions in determining the nature, time and extent of audit procedures and evaluating results thereof.

In the given situation, revenue from operations of the company have increased from ₹ 80 crores to ₹100 crores despite its operations being affected by fire for about two months. Further, despite loss of inventories to the tune of ₹ 5 crores, financial statements reflect increase in net profit before tax from 7.5% in year 2022-23 to 10% in year 2023-24. Thus, approach of CA D lacks professional skepticism.

In spite of these unusual circumstances, the auditor has decided to rely upon same tests of details as performed in the previous years. The nature and extent of audit procedures need to be suitably altered considering changed circumstances.

He may include substantive analytical procedures to analyse variations and seek necessary explanations from management. In case of doubt about the reliability of information or indications of possible fraud, Standards on Auditing require auditor to determine what modifications or additions to audit procedures are necessary to resolve the matter. CA D, the auditor of a listed company, shall document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.



STUDENT NOTES

Prof. Skepticism

Q15

(b) The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Discuss any five examples of professional skepticism. (5 Marks) (MTP S2 April 25)

Ans: Professional skepticism includes being alert to, for example:

- (i) Audit evidence that contradicts other audit evidence obtained.
- (ii) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- (iii) Conditions that may indicate possible fraud.
- (iv) Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- (v) Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
 - Overlooking unusual circumstances.
 - Over generalising when drawing conclusions from audit observations.
 - Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.



STUDENT NOTES

Prof. skepticism

Q16

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 Jan25)

Ans:

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.



STUDENT NOTES

objective of Audit
I. Limitation of Audit

Q17

2(c) 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.

(3 Marks) (May 24 - Exam Questions)

Ans:

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: -

- (1) 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.
- (2) 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.

- (3) 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.
- (4) 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.
- (5) 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.



STUDENT NOTES

IL of Audit

Q18

(c) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. Explain. (4 Marks)

(MTP S2 April 25)

Ans: 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) The Nature of Financial Reporting: The preparation of financial statements involves judgment 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) The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence such as:
 - Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.
 - Fraud may involve sophisticated and carefully organised schemes.
- (iii) Not in the nature of Investigation: An audit is not an official investigation into alleged wrongdoing. 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: Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.

- (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.



STUDENT NOTES

I. Lim of Audit

CHAPTER 2 AUDIT PLAN

Q.1

1(a) AP & Co., Chartered Accountants, are appointed as statutory auditor of Heavy Industries Limited, a listed company engaged in manufacturing of electric vehicles, for the F.Y. 2023-24. As per the recent guideline issued by the regulatory authority, every listed company is required to maintain the digital database of all those personnel who could access the books of the company to avoid Insider Trading. In case of non-compliance, hefty fines may be imposed on the company. CA P is the engagement partner from auditor firm for the audit of Heavy Industries Limited. During planning, CA P planned that he would inquire from in-house IT Head of the company about the maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines. In the light of above facts, explain :

- (i) Whether CA P is required to consider about the maintenance of digital database while framing audit strategy ? (3 Marks)
- (ii) Whether the procedures planned by CA P are in line with SA-300 ? (2 Marks)

(Exam Jan25)

Ans: (i) As per SA 300, "Planning an Audit of Financial Statements", the auditor should 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, key resources to be employed to conduct audit.

The auditor shall take following factors into consideration while establishing or framing audit strategy viz. identify the characteristics of the engagement that define its scope, consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts, etc.

In the given situation, the regulatory guideline requires Heavy Industries Ltd., a listed company, to maintain a digital database of all those personnel who could access the company's books to prevent insider trading. Further, hefty fines may be imposed in case of non-compliance with this guideline. Therefore, it is very essential that auditor while establishing overall audit strategy evaluate whether the company maintains such a database and complies with the regulatory requirement.

Thus, in view of above, it can be concluded that CA P should incorporate the assessment of digital database maintenance into the overall audit strategy.

(ii) As per SA 300, “Planning an Audit of Financial Statements”, planning includes the need to consider, prior to the auditor’s identification and assessment of the risks of material misstatement, such matters as obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework, etc. In the given situation, CA P planned to inquire from in-house IT Head of the company regarding maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines. Inquiry with the IT Head regarding the maintenance of the digital database is an appropriate procedure to understand whether the company complies with the regulations. This inquiry will help CA P in obtaining a general understanding of the legal and regulatory framework applicable to the company and how the entity is complying with that framework and other risk assessment procedures.

Thus, the planned inquiry with the IT Head is in line with SA 300.

**STUDENT NOTES****Q.2**

10. ATL Pvt. Ltd., a leading manufacturing company, appointed CA Atul as an auditor for the year 2023-24. Given the complexity of the company's operations and the need for a systematic approach, he plans to design a detailed audit programme to ensure the accuracy of financial assertions. As a CA student, if you were assisting CA Atul in constructing this audit programme, what are the points you will keep in mind?

(RTP MAY25)

Ans: For the purpose of programme construction, the following points should be kept in mind:

- (i) Stay within the scope and limitation of the assignment.
- (ii) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
- (iii) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- (iv) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- (v) 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.
- (vi) Consider all possibilities of error.
- (vii) Co-ordinate the procedures to be applied to related items.